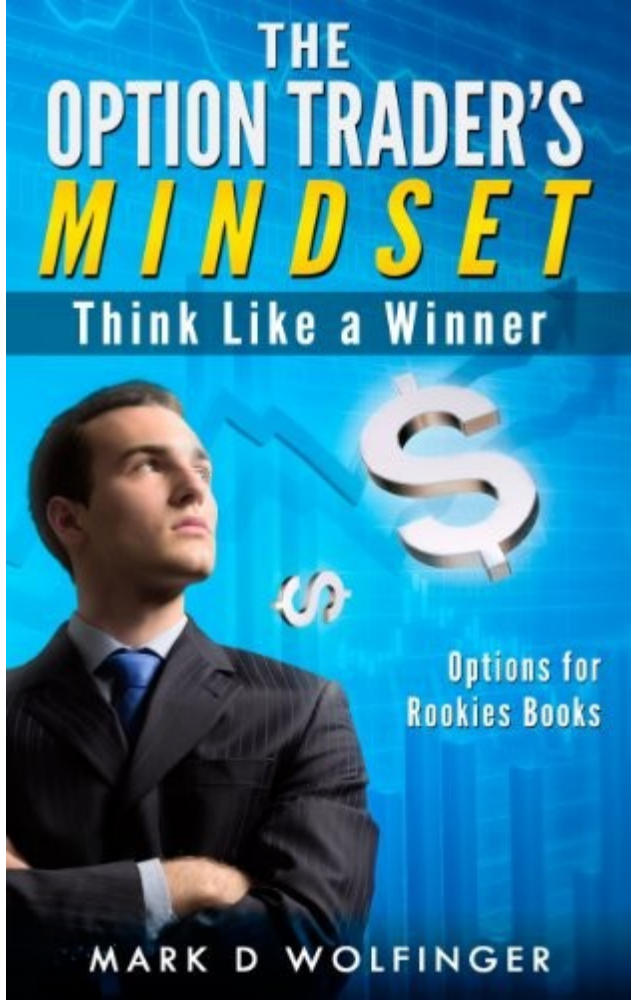
THE
OPTION TRADER'S
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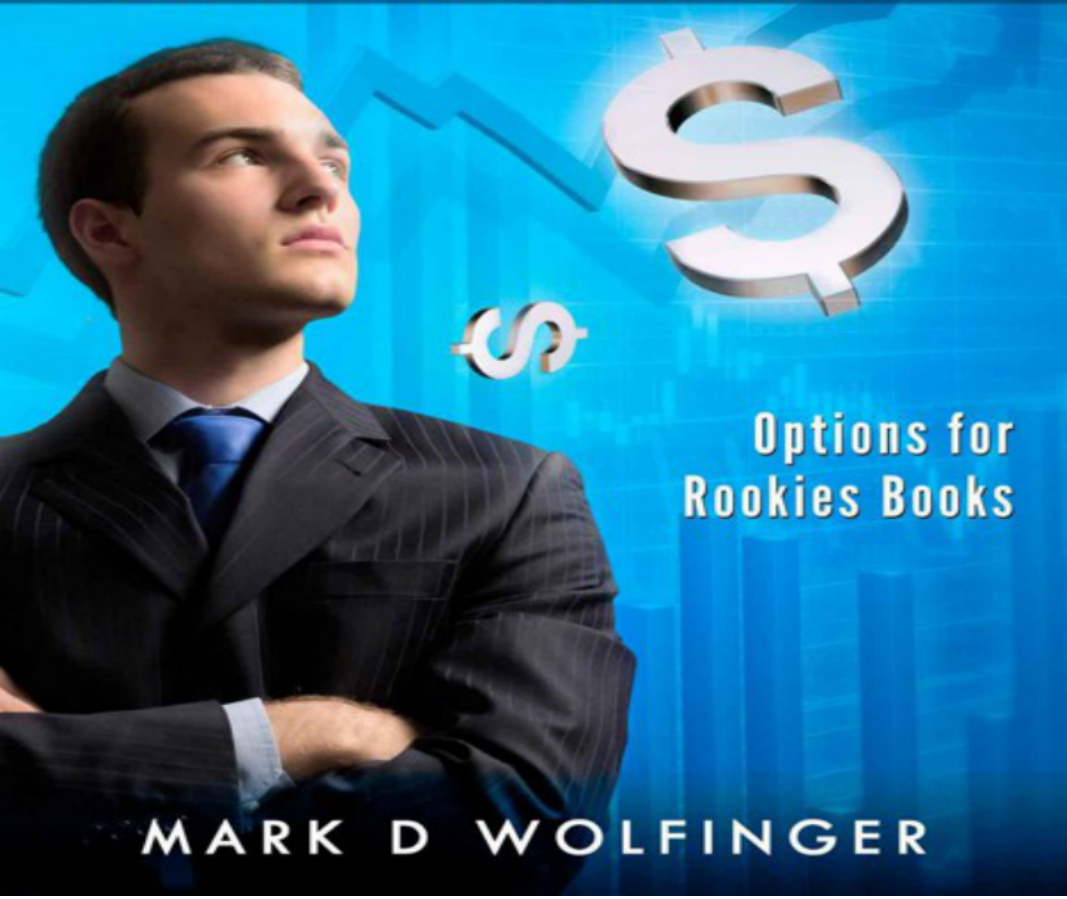
MARK D WOLFINGER

VISIT...

THE OPTION TRADER'S MINDSET

Think Like a Winner



Options for Rookies Books

MARK D WOLFINGER

THE OPTION TRADER'S MINDSET: THINK LIKE A WINNER

MARK D WOLFINGER

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Introduction to Options: The Basics

Mark D Wolfinger

Published by Options for Rookies Books

Requests to the publisher should be addressed to Mark D Wolfinger; 1717 Dobson Street; Evanston, IL 60202

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FOR PENNY

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INTRODUCTION

Becoming a full-time trader has great appeal for many people, not only because of the potential to make a great deal of money, but also because it provides a path to independence and being your own boss.

Doing the work necessary to find success is less appealing. Contrary to popular belief, one cannot decide to become a trader one day and begin earning good money the next. It is a business that requires skill, knowledge, and time for an education.

This book is designed as a guide to developing a proper mindset, or way of thinking, that increases any trader's chance of achieving better results. This is not 'all you need to succeed.' Instead it is a collection of commentaries with a common theme. Each is designed to suggest a way of thinking about trade decisions and finding a good (efficient) method for handling the situation.

To become a winner in the option-trading game, it is important to have a proper mindset. This is not a question of having confidence or believing that you can do anything if you put in a good and honest effort. It is more subtle than that.

Do you remember the E*Trade commercials that aired during the technology bubble of the 1990s? The ads suggested that opening an account is the path to buying your own island, or the equivalent of winning the lottery. Sure those ads were humorous, but behind them was the destructive mindset that anyone could become rich by trading. There is no doubt that many people adopted that mindset by quitting their jobs to trade full time. As long as those new traders remained bullish and as long as the market cooperated, there was easy money to be made. However, times change and these inexperienced traders had no idea how to adapt to the new market environment. When the bubble burst, few adapted and fewer survived. They had one idea that worked. They followed a single (bullish) mindset, and when it stopped working they were doomed.

In this book I refer to situational mindsets that can harm a trader's performance. None is as dangerous as the one mentioned above. However, when we adopt a trading methodology based on ideas that we KNOW (or assume) are true; it is difficult to find the path to becoming a winner. No matter what we do in our lives, an ever-present risk is that *we do not know what it is that we do not know*. The situation is even worse when what we 'know' turns out to be

incorrect.

I hope to instill in each reader the belief that there is more than one way to look at any given situation and that the obvious is not always the better choice. The correct method for tackling a trade problem is not to seek the majority opinion, but to think logically and adopt a logical plan.

These thoughts are targeted to, and appropriate for, the newer trader. However, many experienced traders develop ways of thinking and making decisions that become habits. These can be destructive at worst—and inefficient at best. All traders below the expert level should find something of value in this book—something that has a positive influence on their trading results.

This collection of essays covers a variety of TOPICS on trading options. It contains both fresh material and previously-published (updated and expanded) blog posts. Some ideas are not universally accepted and are controversial. That is why they are so valuable. The common theme among them is that an option trader can learn to make more money by thinking differently. I encourage readers to examine why they act as they do in the specific situation described.

Perhaps you will make changes to your trade methods. Perhaps you believe that your current solution to a problem works better than the suggestion. That's fine as long as your rationale is based on logic and not on the assumption that your current way of thinking has to be correct. Please pay attention to the warning: 'the greatest risk of all' in Chapter 1 and do not discard it by thinking that it does not apply to you.

Take the lesson in each chapter as a strong suggestion. Think about it. Decide whether it applies to you and whether you can live with it. If it feels so wrong that you cannot adopt it, then you will have made a decision based on something other than grabbing onto the obvious.

As we grow as individuals we get set in our ways. We develop habits and methods for accomplishing certain tasks that feel natural to us. Many of these are simple tasks – as simple as how we brush our teeth or open an envelope. These requires so little thought that we accomplish these tasks mechanically.

Other habits are not as innocuous and make a difference in our lives. Some people cannot be bothered balancing a checkbook. They assume the bank makes no errors and that there is always enough money on deposit to avoid bouncing a check. This is a deliberate action rather

than a habit, but the mindset is that the shortcut is sufficient. In this example, it is *not likely* to result in harm. However, it can—on occasion—turn out to be a very costly mistake.

When trading, we develop ways of thinking that can be classified as something so obvious that it requires little (or no) thought. For example, I cover any short option position when there is too little reward to justify any risk. I enter the 5-cent bids without much thought because I want to utilize this 'safety play'. How can that result in a problem mindset? The risk is that adopting one 'no thought required' mindset may lead a person to adopt other such shortcuts at inappropriate times.

Most traders are unaware that they developed such mindsets. One example is the trader's need to hold onto a losing trade until it gets back to even. Does that sound familiar? For many, this idea is 'natural.' No other way of thinking feels possible. I hope to demonstrate that this is a mindset worth eliminating.

This is not indoctrination. Abide by the truth as you see it (and I will do the same). My goal is to make you aware of these issues, allowing readers to think about ideas that may have become habitual. This leads to better decision-making. Remember that 'good' decisions do not always produce the best possible result because trading is a statistical game, and part of the time odds-on favorites disappoint while unlikely events come to pass. When you make those good decisions consistently, your chances of becoming a winning trader improve.

Evanston, Illinois;
January 2013
Updated June 2014

PART ONE

Background Thoughts

CHAPTER 1
THE NATURE OF RISK

This chapter describes the glue that holds together the thoughts in this book.

We all know that investing or trading or gambling—in short, using money to earn money – involves risk. On rare occasion, there is the possibility that our investment capital will be stolen. We may fall into the hands of cheats, thieves, or scammers, Madoff (Bernie Madoff pleaded guilty to stealing billions from investors in a Ponzi scheme), Wasendorf (Russ Wasendorf, Sr. was charged with making false statements to the Commodity Futures Trading Commission. Beyond that, he admitted embezzling more than $200 million from clients of his brokerage for futures traders) and others are lurking.

The possibility of going broke via trading is much greater. Believe this: The only satisfactory method for preventing that from happening is to be certain that you never have too much money at risk at any one time.

Let's turn our attention to making money because that is the ultimate goal for traders. Earning money as a trader is a skill. Some folks believe that anyone can succeed. Others believe that if you buy quality stocks and hold forever, you cannot fail. This discussion is not about comparing a trader with an investor or 'holding forever' with frequent trading. This discussion involves what it takes for you, the reader, to improve your results when making trade/investment decisions.

Before anyone can expect to succeed, that trader must develop a healthy respect for risk. But we keep score by the rate at which our bankroll grows. That means we fail to recognize the risk we are taking (if the trade goes very wrong) because we are blinded by the size of the possible gain. Some traders may never reach the point of understanding that being a successful risk manager is the key skill required for success. Many of the ideas offered here are designed to give traders a better understanding of how to manage risk.

If we have, or can develop, the correct personality traits (lack of stubbornness for one); if we understand the detailed workings of the product we are trading (you would be amazed by how many people have no clue); if we take the time to learn before we place our money

at risk (novices tend to be very eager to begin); then we have an excellent chance to succeed as a trader.

THE GREATEST RISK OF ALL

A blog post by R.P. Seawright describes the over-riding concept of 'the greatest risk of all.' It is a topic that falls under the heading of behavioral finance. It is difficult to get most people to fully understand the concept of exactly what is risky. I always talk about controlling position size but the 'greatest risk' is of quite another variety. It is difficult to recognize.

The following is an edited and abbreviated version of that post:

> "As I have tried carefully to point out, risk is difficult, if not impossible, to define fully, much less quantify. But one thing we know for sure is that *risk is risky*. Taking too little risk or too much risk is risky.
>
> "To this point in the 12-part series I have only alluded to **the greatest risk of all**. In the immortal words of Pogo (A Walt Kelly's 1914 comic strip character): "We have met the enemy and he is us." This 'bias blind spot' is not 'only' true, it's *really* true, true in spades. It is our overarching problem.
>
> "We all tend to share the inability to recognize that we suffer from the same cognitive distortions and behavioral biases that plague other people**: if we believe something to be true, we quite naturally assume those who disagree are wrong. Our beliefs reflect the objective facts because we think they are true**. *Duh*. Our thought process goes something like this:
>
> "I've thought long and hard about it and I'm convinced I'm right. Of course, that line of thinking doesn't convince anybody else. We are not particularly comforted when others assure us that they have looked into their own hearts and minds and concluded that they have been fair and objective. But we believe that they are biased (and we are not).

> **"*The existence of behavioral minefields is difficult enough. That we don't think they apply to us is often fatal to our judgment*** [Emphasis mine: MDW]

"So what are these biases?

"Confirmation bias **means we are not the impartial judges of information that we like to think we are. It's why Fox News and MSNBC viewers tend to see each other as some version of stupid, delusional and evil, no matter the situation or circumstances**.

"Optimism bias: we think we're right far more often than we are. [MDW: This is why I always want you to have a proven track record of success before making certain wagers.]

"Our **self-serving bias** pushes us to see the world such that the good stuff that happens is our doing, while the bad stuff is always someone else's fault: We couldn't have foreseen that market crisis.

"Our **loss aversion bias** means that we feel losses between two and two-and-one-half times as strongly as gains. It favors inaction over action and the *status quo* over any alternative.

"The **planning fallacy** is our tendency to underestimate the time, cost, and risk of future actions, and at the same, time to overestimate the benefits thereof. It's why we overrate our own capacities and exaggerate our abilities to shape the future. It's one reason why every building project tends to have cost overruns.

"Intuitively, we think the more choices the better. The sad truth is that too many choices can lead to decision paralysis due to information overload. It's why participation in 401(k) plans among employees decreases as the number of investable funds increases. It's also why we so readily rely upon rules of thumb rather than getting *down and dirty* with the data.

"We routinely run in herds —large or small, bullish or bearish. Investment institutions herd even more than individuals in that investments chosen by one institution predict the investment choices of other institutions by a remarkable degree. It's why market bubbles occur—in tulips, baseball cards, internet stocks and real estate.

"We inherently prefer narrative to data — often to the detriment of our understanding. That's why ridiculous conspiracy theories abound, even among otherwise smart and intelligent people, without a bit of

good evidence. We are all prone to recency bias, meaning that we tend to extrapolate recent events into the future indefinitely.

"Bloomberg surveys market strategists on a weekly basis and asks for their recommended portfolio weightings of stocks, bonds and cash. Even though they are the supposed "experts," their collective views are a great contra-indicator. The peak recommended stock weighting came just after the peak of the internet bubble in early 2001 while the lowest recommended weighting came just after the lows of the financial crisis. That's recency bias.

"Again, the existence of these behavioral and cognitive deficiencies is difficult enough. That we tend to think they're other people's problems and not our own—the bias blind spot—is the icing on the cake. As I have tried to point out repeatedly, *risk is risky*. Because of our behavioral biases and our tendency to think they don't apply to us, the odds are overwhelming that we are going to miss or ignore many of the risks that plague us.

"**The greatest risk of all** is staring us in the face when we look into the mirror. At least, the greatest risk of all is staring at YOU when you look into the mirror."

That is an excellent piece of writing and goes a long way in explaining a difficult-to-understand concept.

It is not easy to recognize that we have such biases. It is even more difficult to overcome it. However, this book is all about doing just that. I suggest ways of thinking about situations (mindsets) that I *know* are logical, and thus I naturally assume that they would be helpful to any trader.

I 'know' they help me make good trade decisions and are financially beneficial. I encourage readers to give them serious consideration. I'm sure that the beginning trader will benefit by adopting many. Even the experienced trader should find some nuggets worthy of consideration.

Please be careful before discarding any of these ideas without a second thought. It could be your conformational bias that is tricking you into believing that the specific idea is without merit. Of course, it could be my bias that makes me believe that it is important to share these ideas!

The Winning Mindset

Thought Process of Typical Successful Trader

We traders do not always reach logical conclusions. We believe we do, and that's the problem because it gives us no incentive to look for a way of improving how we conduct business or live our lives.

Be open to the idea that each of us is completely unaware that we believe some things that are just not true.

CHAPTER 2
SET ASIDE YOUR CURRENT MINDSET

The idea behind writing this book is to offer my ideas on how you can develop a way of thinking that is beneficial to your trading career. These are not lessons on how to select a trade or strategy.

The purpose is for you to discover, and then abandon, ideas that harm your trading results. This task is more difficult than it may appear (review Chapter 1 if you believe it is easy). Only brand-new traders may have escaped the formation of bad habits (money-losing mindsets).

HOW I MOVED BEYOND A FAVORITE MINDSET

I spent more than 20 years as a market maker at the Chicago Board Options Exchange (CBOE). During that time I was a risk taker. I held large positions (naked short options) for no sound reason. I also refused to cover those options when the price reached its lowest possible level (In those days options traded in fractions and that minimum was 1/16, or $0.0625).

Looking back, I'm sure it was an egotistical play. I was demonstrating to a world of people who did not know orcare—that I was a big trader. To make a long story very short, big positions turned into big profits—until they didn't. Big market moves left me holding naked shorts that had moved into the money. Because I was foolish enough to own these short positions in the first place, I was also too foolish to cover. That was a very expensive lesson. And it happened more than once because it was difficult for me to accept the fact that an option that was "obviously" worthless could turn around and bite me.

Today, I know better. I do not hold naked short positions and suggest the same strategy to my readers. The only time that I consider it reasonable to hold naked short options occurs when selling a naked put (cash secured) because I am willing to own shares of the underlying asset. However, I recently recognized that naked options, in small size, are appropriate for experienced traders who know how to handle such positions. I never thought I would accept the idea of selling naked options because I had so much trouble with them. I now understand that *it was not the naked short option that was the problem*. Instead, it was me— a combination of selling too many options and refusing to adopt a sound plan to manage losses.

I overcame inferior mindsets in three specific categories. I now believe:

- Size kills. It is imperative for a trader to have a true picture of what can go wrong and how bad it can get—no matter how unlikely. The trader should never allow—call it bad luck if you must—to wipe out a trading account. [Former mindset: bigger size leads to bigger rewards]

- Owning positions with little to gain and a lot to lose is not trading. It is gambling. [Old mindset: These options are going to expire worthless. There is nothing to worry about and there is no reason to waste 1/16 by covering.]

- Owning short-term positions with negative gamma (A position in which *losses accelerate* as the market continues to move in one direction) is a high-risk play. The possible reward must be high to justify taking risk.[Old mindset: I'll cover immediately if the market moves against my trade – but I knew that was not the truth. I knew I was stubborn and lacked discipline with naked shorts.]

As a retail trader today, I always cover short spreads when they reach a low price. I almost never hold a short position into expiration. I pay between 10% and 20% of the original premium to cover positions voluntarily. There is no urgency. I enter the bid at the first opportunity, and wait (unless prudence requires paying a higher price due to increase danger). I gladly sacrifice the chance to earn the remaining premium because I gain the peace of mind that comes from owning less-risky positions (less negative gamma).

WEEKLYS OPTIONS

In 2005, the CBOE listed (Standard & Poor's 500 Index) options that expire every week. Eventually, other indexes were added, followed by the options on most actively traded stocks. The list is published every week:

I was unwilling to trade very short-term options because of my past history with being short options when there were only a few days remaining before the options expired. I now recognize that I had to set aside that bias to become more successful. Working with beginner and intermediate traders at Options for Rookies, required me to explain all trade alternatives, and "Weeklys Options" (The official CBOE trademarked spelling) generate a lot of investor interest.

My philosophy: I talk about a trade, offer my opinion and guidance, and then encourage you to reach your own conclusions on whether my mindset, or an alternative, works for you.

Thus, I added weekly expiration plays to my repertoire. It was important to gather information, gain trade experience, and decide whether I could help traders earn money with weekly expirations.

I overcame a strong mindset by looking at the bigger picture. You can do the same.

In Chapter 7, we'll take a closer look at trading weekly iron condors.

The Winning Mindset

Luck vs. skill: A trader must have confidence in his/her ability to make good decisions under duress. However, that confidence has to come from more than a 'belief.' A proven track record of profitable trades is ideal.

However, I do recommend that anyone should allow a winning streak to convince him/her that he/she suddenly became a superstar. I know when good results come from good luck (i.e., a well-behaved market) and when the trader made a significant contribution to his/her success (had the discipline to make a risk-reducing trade and the good judgment to select the trade that changed the position from 'at risk' to 'worth holding.'

Similarly, I recognize when I fail to act in a timely manner or when I make a poor decision. Example: when I choose a trade that gives me

an improved probability of earning an eventual profit, but which was not very effective in reducing risk.

It is easy to ignore the fact that the *sole purpose* of adjusting a trade is to reduce risk. We also want to own a good position post-adjustment, but the plan should be *to pay attention to managing risk first, and to worry about profits second*. The losing mindset is to worry about profits first, and being less concerned with solving the problem of too much imminent risk.

I separate the 'my fault' results from 'bad luck' losses. When we enter a trade that has an initial probability of earning a profit 90% of the time, that does not mean that we can close our eyes and hold the position until it expires. That 90% probability of success means that we should expect to incur a loss approximately 10% of the time. It is our job to stay on top of the trade and reduce risk when necessary. The trade may have been 90% when initiated, but it can easily become a trade with a 50% chance of success when the underlying stock price changes. Most of the time, those new odds are not good enough for me to want to continue to hold onto my position.

When those inevitable losses occur on 10% of that type of trade, it is not easy to recognize that it was a normal result. Instead, we tend to count such losses as the result of bad luck. After all, when a 90% favorite turns into a winner, surely that is bad luck, isn't it? Losses are inevitable. It is the task of a successful trader to minimize the amount of money lost on these trades.

Individuality. I never say that my ideas are best. I suggest that you consider each idea from your own perspective. I anticipate that these ideas (call them my trading philosophy) will seem logical to you. If you think for yourself and soundly reject one (or more) of my pet ideas, then I say 'good for you.' If you take the time to give serious consideration to these ways of thinking about trading, I'm confident that you know your personal situation better than I do, and that you will make the right decision.

I offer ideas that you may not have previously considered. Not 'how to make money by trading,' but how to reason well and be well placed to make good trade decisions, unencumbered by obvious, but flawed thoughts.

Weekly trades. When I look at positions that expire weekly, I know that trading short-term credit spreads comes with high reward

potential because time decay is rapid. It only takes 2 – 3 days for those options to lose much of their premium. We earn profits when the market behaves.

Trading short term credit spreads comes with plenty of risk. Because these options are not very far out of the money, and the premium for selling them is on the small side, when these options become ATM and then ITM options, losses mount very quickly.

The best compromise between risk and reward is to trade weekly iron condors in small size. It is not smart to take too much risk when the chances of something bad happening are so high. Yet, the rewards are attractive (6 to 8% per week is a reasonable target) that anyone who has the time to monitor the position should think about trading these negative-gamma trades. They are not suitable for everyone.

There is more on Weeklys in Chapter 7.

CHAPTER 3
TRADER MINDSETS

Potential traders are human and when they undertake anything new—including trading—they come to the table with certain preconceived notions or habits, which I'll refer to as mindsets. It pays to take advantage of your education and experience and apply appropriate lessons to any new challenge, including becoming a successful trader/investor.

The problem arises when those mindsets, developed over a lifetime, are in conflict with habits that are required to succeed in the new endeavor. Bad habits are difficult to overcome, and that can make it difficult to succeed as a trader. Note that I am not suggesting it is impossible to learn the new skills, but only that old habits can get in the way.

I often write about the importance of good risk management and money management. Someone who has spent years accumulating credit card debt, living beyond his/her means, or buying things to impress the neighbors (or spouse/partner) obviously lacks the discipline to be careful when managing money. I'm not suggesting a trader must be frugal. But trading discipline is not easy for someone who spends money carelessly and does not understand the importance of avoiding debt—especially at high (credit card) interest rates. Being careful with trading dollars and getting good value from your broker (commissions, fees and good trade executions) contribute to success. The frivolous spender may have a difficult time refusing to initiate a new trade because the entry price is just not good enough.

On the other hand, it's possible that the trader who developed a very frugal lifestyle may not be willing to invest money where it is needed (insurance; position adjustments). Or even worse, may be inclined to exit every trade that is not an instantaneous winner. It's certainly not frugal to take excessive risk, but an inclination to watch every penny can get in the way of trading decisions. That manifests when traders refuse to make a borderline trade for the sole purpose of saving cash on commissions. That trait may make it difficult for the trader to pay $0.05 or $0.10 to exit a position and remove all remaining risk – locking in a profitable trade. Maybe this is one reason why so many who advocate a frugal lifestyle also prefer passive investing.

Unless you own a portfolio of very conservative positions, it is inevitable that you will find yourself in an uncomfortable situation (more often for aggressive traders) in which the risk of losing money is greater than you prefer. It's far better to make decisions based on common sense, previously-made trade plans, and the ability to think well under pressure than refusing to spend money on risk management.

Individuals who are accustomed to being ruled by their emotions are not going to do well under these conditions. It's true that there is recent evidence that we cannot completely ignore our emotions when making important decisions, but looking at the bigger picture, we do not want fear or greed to take over the decision-making process. Thus, if you have a mindset that allows those important, spur-of-the-moment, decisions to be made when emotions are in control of your reasoning, that's deleterious to your chances of winning the trading game. Those who recognize when their emotions are taking over and who can still make decisions with the less-emotional portion of their brains have a big advantage over those who cannot. No matter how conservative you may want to be in your trade selection, there are going to be times when immediate risk has reached an uncomfortable level. Clear thinking is the best pathway out of trouble.

QUESTIONS TO ASK YOURSELF

Do you have the mindset that allows sloppiness in your daily life? Can you overcome it and become more disciplined when trading?

Do you think of trading as playing with Monopoly money? Is trading a game to you? Or do you have the mindset of a gambler? A serious trader, understanding that taking big risk, and losing, can be ruinous – avoids placing too much money a risk at any one time.

Can you develop an understanding of where your comfort zone lies and the importance of trading within that zone? This question may take some real trading experience before you can answer. NOTE: Experienced traders who want to move to the expert level must learn to expand their comfort zones. However, newer traders cannot afford to do that until they have enough experience to be 100% certain that they understand why it is reasonable to move beyond their comfort zone boundaries -- for this specific trade -- at this specific point in time.

My suggestion is simply to be aware of the recommended characteristics of a successful trader (you can find numerous opinions online) and be certain that you are aware of any habits that are in conflict with those desired traits. Being aware is the first step towards not allowing those habits to interfere with your quest.

RELATED COMMENTS

These comments to my original blog post speak for themselves. I highlighted a few of the key words.

> "A lot of people who'd like to trade never even make it to this stage of self-examination. Hoping to find the holy-grail of indicators or strategies that never lose money is a lot easier than taking the time to decide which strategy fits the individual AND trying to improve personal risk management. **It's hard work!"**
>
> "Important to know yourself before slinging precious account money. It's been said about trading; "**If you are trying to self-destruct—you've picked the perfect medium.**"

The Winning Mindset

Learning to trade takes as much effort as learning other skills. I know that the way I conduct my business and personal life provide an indicator of how I will conduct my trading business. And trading is a business, even for the part-time investor. I may not be able to change who I am, but if I recognize that certain traits are harmful for trading, then I will be aware of those traits/habits and recognize when I must think differently.

One final point: If you do not have what it takes to be a trader, the winning mindset is to save yourself the heartache and become a good long-term investor instead.

CHAPTER 4
BRAGGING RIGHTS

Do traders go out of their way to take extra risk in an effort to show off? Do they want to boast to buddies, spouses, or teachers?

In his book The Missing Risk Premium, Eric Falkenstein writes about why there appears to be a negative risk premium, defined as a situation in which taking on more risk results in a lower return. Investors who take more risk should be compensated, and achieving lower returns for more risk is a poor result. The problem may be that the risk takers don't recognize that their returns are insufficient to compensate for risk.

Eric notes that negative risk premium should be expected in lotteries and gambling, but not in less trivial areas such as options and stocks. He suggests that 'signaling' is the cause. Investors want to show other people (other traders, friends, family etc.) how awesome they are by trading just like a real alpha-generator would.

If the mark of an expert investor is aggressiveness, then any aspiring expert must follow suit. When expert wannabes are told to focus on low volatility stocks or ETFs, they find that advice to be dull and unacceptable. After all, that's not how the 'big boys' trade. There have been studies that suggest the desire to impress others results in the acceptance of extra risk. That would not be so bad if the returns justified the risk.

Note this distinction in how people define Risk Premium: Greater Risk must *offer the potential* for greater rewards or else no one would take that extra risk. However, some people translate that as: Greater Risk *results in* greater rewards. It does not do that. It only allows for the *possibility* of larger rewards.

When we trade at home with our computers, there should be zero incentive to trade more often, or to take on too much risk because no one will know. There is no person around who could be impressed by our trade decisions. And if we take more aggressive action, again no one will know unless we advertise our results. Sure, we share our performance with spouses, but probably not with anyone else. So is 'signaling' really an issue? It is for those who trade in a group environment (prop shop) or are involved with an investment club or who meet with trading buddies on a regular basis.

For my personal investing, I prefer not to own index funds. Perhaps it is too boring. Perhaps there is no ego satisfaction. I don't know the reason. However, being honest, I know that indexing has to be the best possible choice for vast majority of investors – especially for those who lack the time to develop the skills required to invest/trade successfully for themselves.

The Winning Mindset

Beginners should focus on avoiding mistakes. Take your time. Learn. Gain experience. Trade SMALL positions or use a paper-trading account. Understand what you are doing. Making money comes later and protecting your assets comes first.

The initial goal for new traders must be to survive, not thrive. As a trader gains experience and has accumulated a track record of making money on a consistent basis —that means more than just a few positive months or winning trades —that is the time when the trader can *consider* making a small increase to position size. That is when the trader can think about practicing more complex or more aggressive strategies. Not sooner.

The winning mindset is to be aware of the dangers of signaling. If you do enter into a discussion with others about trading, that should be a beneficial experience for everyone. It's good to learn from others and to share success/failure stories. However, if you cannot be part of such a group without signaling that you are 'a player,' it is best to go it alone.

PART TWO

Strategies

CHAPTER 5
CHOOSING AN OPTION STRATEGY

It is not the option strategy that makes money; it is the trader who understands when and how to use any given strategy who earns the profits.

That first sentence of this chapter is also the concluding sentence. It is a complete mindset all by itself. Please believe that it is true and hat it applies to you. You are more important to your trading success than the strategy you adopt.

A substantial part of knowing how to use any strategy includes an understanding of risk management techniques. Such techniques vary from one option strategy to another. There is no one-size-fits-all method for managing risk for an option trade. You may find a comfortable general concept to follow, but the details of any risk management plan should be suitable for the specific trade.

Traders fret over strategy selection, believing that if they can only find that 'winning strategy' all will be well. The truth is that we should select a strategy based on our expectations for the stock market, or at least for the specific underlying asset. When we have no expectations, or when we prefer to trade by being 'market-neutral', then one of the 'income-generating strategies' becomes suitable.

- Some strategies perform better than others when market volatility changes. If you want to take a position that benefits from an increase in market volatility, you could:
    - Own positions with positive vega
    - Buy calendar or diagonal spreads
    - Bullish traders can own ITM calls instead of stock, benefitting when IV increases.
    - LEAPS (Long Term Equity AnticiPation Series) options offer the most positive vega, but generally require payment of significant time premium.

- Trade an appropriate option strategy using a volatility indexes, such as VIX or VXX, as the underlying asset.

- 'Income-generating strategies' benefit from time decay and are best used when the trader anticipates a range-bound market or has no opinion on market movement.
  - Covered call writing or the sale of cash-secured puts.
  - Credit spreads or debit spreads. Reminder: When the strike prices and expiration are identical, buying (debit spread) a put spread is equivalent to selling (credit spread) the call spread. Similarly, buying a call spread is equivalent to selling the put spread.
  - Winged spreads: condor and butterfly. Also broken-wing and iron varieties.
  - Calendar spreads and diagonals offer both positive vega and positive time decay.

- For directional plays, the strategy choice depends on how vigorously bullish/bearish you want to be.
  - Avoid buying OTM options as a speculative bet. These options are cheap for a reason. Yes, you can make a lot of money—but only if you are correct three times. The stock price change must be large enough, in the right direction, and happen before the options expire. Too many novices buy OTM options, watch the stock rally (or fall) as predicted, but find that their options expire worthless.
  - Owning ITM options offers a good potential return when the stock moves enough to overcome the time premium.
  - When slightly bullish, I recommend selling out-of-the-money put spreads. Profits are limited, but the probability of earning a profit is high. Sellers of put spreads also earn money, even when their prediction fails to come true. In other words, if the stock price holds steady or declines by a small amount, the trade is profitable.
  - When slightly bearish, sell OTM call spreads.

- Buy OTM calendars or butterflys when they are inexpensive (IV is low).

VARIATIONS ON A THEME

When the market is unsuitable for your favorite strategy, that's when the prepared trader pulls a modified strategy out of his 'Arsenal of Trade Ideas.' Let's look at iron condors as an example.

It may feel right to abandon iron condors when volatility is increasing (negative-vega positions do not fare well when IV is rising). If a trader has the patience to wait, he is likely to achieve better results *after* volatility has peaked and the markets are beginning to settle down. Active traders prefer not to wait because that rising option premium makes it very tempting to open new positions.

- If you prefer not to sit on the sidelines while waiting, that's okay. However, do not use your tried and true strategy when you know that it is not currently appropriate. Dig into your arsenal of trading strategies for something suitable.

When markets are volatile, there is another threat: OTM positions can move ITM very quickly. In such an environment, if we still prefer to trade iron condors, the winning trader modifies his/her approach to trading iron condors.

One idea is to own iron condor positions with longer lifetimes. There are two major benefits: Less negative gamma (longer-term options have less gamma and that means that market moves are less painful) and more negative vega (i.e., longer-term options have much more vega than shorter-term options). Make this play when you anticipate that volatility will soon be on the decline). Longer-term condors are well-suited for those volatile markets. This trade (longer-term iron condors) is especially successful when the positions are not initiated too early. Why? Because rising IV is going to put these trades underwater and sound risk management may require exiting the positions with a loss. It is safer to enter when you believe IV has peaked. Avoid the temptation to jump in as soon as IV begins to increase.

When the market is slowly (i.e., without volatility) but steadily moving in one direction, that's time to consider yet another kind of iron condor: If you believe the market is trending, then there is no reason to sell both call and put spreads. If you are comfortable with making directional trades, then sell only call spreads or only put spreads and temporarily forget about trading iron condors.

Warning: Adopting one or more of these modified iron condor strategies is not be suitable when it pushes a trader outside his/her comfort zone. The truth is that the long-term goal for any trader is to gradually expand the borders of the zone. However, when considering a new or modified strategy is not the right time to complicate your overall trading philosophy.

THE CHOICE

It's clear that the important choice should be based on the trader's market bias. Of course, we can get more sophisticated. The income-generating covered call can be used as a *very* bullish position when the call chosen is out of the money. [There are better bullish plays than this one]. Or the market-neutral iron condor can be traded with a big market bias—based on how far out of the money the call and puts spreads are. [The common iron condor has short options that have equal delta or are equally far out of the money]

Once the trader has selected a strategy (iron condor, for example) to suit his/her market bias, the big decision has been made. Next comes deciding among the reasonable alternatives. The condor is related to the butterfly. Consider these points:

- The maximum profit is earned when expiration arrives and the stock is equal to (or between) the strike price of the short options
- The butterfly and condor (or the iron varieties) are very similar. Each can be traded using only calls or only puts. The condor has space between the options sold and the butterfly does not.
- With the iron variety, both calls and puts are used.

EXAMPLE:

Butterfly: Buy the 100/105 call spread and sell the 105/110 call spread

Buy 1 XYX Jan 100 call
Sell 2 XYX Jan 105 calls
Buy 1 XYX Jan 110 calls

Iron Butterfly: The equivalent trade in which we sell one put spread and sell one call spread

Buy 1 Jan 100 put
Sell 1 Jan 105 put

Sell 1 Jan 105 call
Buy 1 Jan 110 call

Condor: Very similar to the butterfly, but the options sold have *different* strikes. In this example, the spread width is five points: (95 minus 90; or 110 minus 105).

Buy 1 Jan 90 call (put for *iron* condor)
Sell 1 Jan 95 call (put for *iron* condor)

Sell 1 Jan 105 call
Buy 1 Jan 110 call

Both the iron condor and butterfly prosper when markets are stable. However, the 'maximum profit zone' (between $95 and $105 in the example) is wider than with the butterfly. In fact, the maximum profit zone for the butterfly is a single tick wide, i.e., there is only one price ($105.00) where the trader can earn the maximum possible profit.

That wide zone offers a much better chance of earning the maximum profit (equal to the premium collected). It also means that the cost of entry is significantly higher. Translation: Using the same strike price as the center for either strategy, the iron condor costs more to own and the potential profit is less. However, the condor trader has a better probability if earning some profit from the trade. Thus choosing a strategy depends on the trader's goal. Aggressive traders tend to seek larger profits—and more conservative traders tend to gravitate toward a high probability of owning a profitable trade. In other words

○ When the call and put spreads are the same width, the iron butterfly generates a higher premium than the iron

condor. As an offset, the chances of keeping the entire premium are small.

- ○ The condor costs more than the butterfly. As an offset, the condor has a wider profitable price range.

- ○ As time passes the condor builds up profits more quickly than the butterfly.

Calendar/Butterfly

- The ATM calendar or butterfly spread does best when the market is essentially unchanged as time passes. The true difference is that the butterfly is worthless when expiration finds the underlying asset priced outside the wings (the options owned) of the butterfly. The calendar is seldom worthless. [An option must be very deep ITM or very far OTM to carry zero time premium.].

More comparisons can be made, but the concept is the important part. You can choose a strategy that comes closest to meeting your market expectations. However, your job as a trader is just beginning when you do that.

When you open the trade (timing) and choose which specific options to buy and sell (strikes, spread width, expiration date etc.) and set a profit target, you are establishing a trade plan. These decisions are a vital part of any trader's methodology. There are many possible choices, but how to make those decisions is well beyond the scope of the ideas discussed here. The important take away is recognizing that there is far more to trading than picking some options and entering an order.

RISK MANAGEMENT

The above preamble brings us to the major idea that involves the trader mindset. When trading an iron condor (for example), every trader understands that two of the easiest (in terms of figuring out what to do) actions to take when reducing risk are:

- Close the position
- Reduce size by closing part of the position.

However, there are alternative ideas for reducing risk. The idea is to "adjust" the position by making some changes. We refer to those trades as risk-reducing adjustments, or more simply, 'adjustments.'

It is easy to develop a favorite method for adjusting risk. For new traders, I recommend the simplest method of all: Eliminate the position. In other words, when you know that the current position is no longer one that you want to own, then it is time to simply exit the trade. When this happens, you may be locking in either a profit or loss. Sure, we are always happier to lock in a profit, however, getting rid of a position that is losing money and is at risk for losing even more money, is a sound thing to do.

A slightly less aggressive adjustment method is to close only part of the position. Why not exit the entire trade? Sometimes a position becomes too uncomfortable to hold for the simple reason that the underlying asset price has changed and the current risk/reward picture is outside your comfort zone. At the same time, you still like the position (based on your outlook for the stock price) and want to continue to own it. The best choice in this situation is to hold only enough of the original trade that allows you to be comfortable with that position in your portfolio – and to exit the remainder.

For example, if you traded 10-lots of a call credit spread (you bought 10 farther out-of-the-money call option, and sold 10-lots of a less-far-out-of-the-money call option with the same expiration date), and the stock rallied, the probability of losing a considerable sum has increased. To prevent that unhappy event from occurring, it is prudent to cover (exit) anywhere from 3 to 7 of your 10-lot position. Please do not buy back only the option that you sold earlier. Buy some of the same spread to reduce position size and also reduce exposure to loss. This position was initiated as a credit spread and should continue to be traded as a credit spread.

Another commonly used adjustment strategy is the roll. This strategy is discussed further in Chapter 19. It involves covering the current position and opening a new spread that is farther out of the money. Sometimes we use the same expiration date, and sometimes the position is moved to a more-distant expiration date. **NOTE**: This is a strategy for experienced traders because it is easy for the novice to adopt this strategy at inappropriate times and wind up with a position that is even more risky than the one just closed.

There are many other choices. To qualify as an adjustment, two conditions must be satisfied:

- The new position is less risky to own. In other words, both imminent risk (potential loss for the next day or two) and ultimate risk (worst case scenario) must be less than it was before adjusting.
- You must like the new position and want to own it. Do not make an adjustment that reduces risk when the position is not good enough to own. You would be far better off exiting the trade and opening a new position in a different stock or index – as long as the new position looks good to you and is one that you want to own.

Too many beginners roll a position to get out of imminent trouble, only to find that the adjustment trade was a huge mistake.

The successful trader understands that option positions are not created equal and the same adjustment method may not be appropriate for all positions. The successful adjuster reduces risk and always holds good positions. A 'one-size-fits-all' approach to risk management is not efficient.

Risk-management methodology cannot remain constant.

WHEN DOES A SHORT OPTION BECOME A THREAT?

When should any trader be ready to make the adjustment? How do you recognize when 'imminent' risk has become too high?

You could decide based on:

- The number of points that the short options is OTM.
- The percentage of the underlying price that the option is OTM.
- Delta of the option that was sold.
- How much money has already been lost and how that number compares with the maximum acceptable loss (that number should be part of your original trade plan).
- Or any factor that makes the position uncomfortable for YOU to own.

Aggressive traders tend to hold onto positions longer than conservative traders. However, each group may choose its individual exit or adjustment point based on a losing mindset.

For example, the aggressive trader may be too stubborn to make an adjustment when it locks in a monetary loss. Holding under these circumstances is merely wishful thinking and not strategic trading.

The conservative trader may become frightened over a small loss and exit a perfectly sound position.

EXAMPLE FOR IRON CONDOR TRADERS

The aggressive trader may decide that it is acceptable to wait until the short option is only 10-points out of the money (for an $800 index or a high-priced stock) or its delta is near 40 before taking defensive action.

The conservative trader would shudder at those parameters and would choose to adjust when delta reached 25 (or less) or perhaps when the strike was 40-points out of the money.

Neither trader is making a mistake, as long as that trader truly understands the risk/reward situation at all times.

A reasonable-sounding, but incorrect mindset is: “Isn’t it ‘obvious’ that selling far OTM options is a ‘safer ‘play than selling options that are closer to being at the money’?

It is not safe at all. It is quite risky. What fools us is the notion that we have a very high probability of success when selling far out-of-the-money options. Traders who believe that this is ‘safe’ fail to recognize how awkward it can get when the trade does not work out well. It is difficult to make any ‘lock in the loss’ decision when that loss is so much larger than the original premium collected. If the trader decides to cut risk as soon as the loss equals the original premium collected (and this is a fairly common adjustment point for many), then adjustments occur too frequently and it becomes a losing strategy. Imagine selling a spread for $0.10 and exiting as soon as it costs $0.20 to exit. This is simply not viable.

HOW OFTEN TO ADJUST

Note that one important aspect of risk management is deciding how often an adjustment is necessary. It could range from frequent (several times per day) to daily, to 'as needed for risk' to (I shudder at the thought) never. This is yet another of those individual decisions. If you have difficulty deciding how often to adjust , rest assured that you will get a good feel for this as you gain experience. All that is required is a belief that holding onto a position and hoping that it works out well is a bad choice.

I suggest beginning conservatively and adjusting in stages.

The Winning Mindset

> It is not the option strategy that makes money; it is the trader who understands when and how to use any given strategy who earns the profits.

I manage each strategy differently. As an example, when my iron condor uses higher-delta, closer-to-the-money options, I tend to hold the short option until it is at the money because the large initial credit reduces the loss from a worst-case scenario. In other words, with a higher possible gain (collected a higher premium) and a smaller possible loss, the position remains within my comfort zone for a longer time.

Holding onto a position that long is too dangerous when the initial credit is far less. In other words, trading iron condors with options that are far out of the money may feel safe, but it is not. The ultimate risk for such positions is much greater than the potential reward. That is not how we describe a low risk situation.

No matter which trade strategy I choose as an entry, my overall success depends on my skills when managing risk.

Options offer super versatility, and I use the Greeks (Chapter 8) to measure risk and tweak positions.

CHAPTER 6
THE IRON CONDOR MINDSET

Among the popular option strategies is the iron condor. It is a four-legged spread designed to profit when the underlying asset trades within a relatively narrow range. For example, here is a 12-lot position on IBM:

Buy 12 IBM Nov 170 puts
Sell 12 IBM Nov 180 puts

Sell 12 IBM Nov 220 calls
Buy 12 IBM Nov 230 calls

In this sample iron condor, the trader is short 180 puts and 220 calls. The objective is to

- Collect cash when selling the put and call spreads.
- Pay a smaller amount when buying BOTH spreads to exit the trade.

When the underlying asset (IBM in this example) is not priced below $180 nor above $220 when expiration arrives, then all four options expire worthless and the trader keeps the original cash premium. That represents the ideal result.

When the underlying threatens to move through either of those strikes ($180 or $220), then the trader usually (wisely) makes a risk-reducing trade. The specifics of managing risk are beyond this discussion, but are worthy of a lengthy book of their own.

The position appears to be a combination of two spreads: Short one call spread; short one put spread. And although it is exactly that, the winning iron condor trader knows that the position is really a single position in which each of the four options serves a purpose. In other words, it should not be thought of as if it were two separate positions.

- I am short one call spread. If the market declines I will cover (exit) that spread to lock in a profit.
- I am short one put spread. If the market rallies I will cover that spread to lock in a profit.
- When I buy both, I will have successfully completed the trade.

- I own one iron condor position. To earn a profit, I must cover both spreads by paying less than my original cash credit. If I cover *either* the call or put spread, that does not result in a profit. Repeat: There is no profit when exiting only half the iron condor position.

The differenceis subtle, but important. It is very tempting for the newer trader to take a nice profit—as he sees it. If he sold the call spread, collecting $120, it seems obvious that covering that spread when 50% of the premium has disappeared results in a profitable trade. In other words, by buying the call spread at $60, this trader believes that he locked in a $60 profit.

That is an illusion. *There is no profit.* The position is an iron condor and not two separate spreads. This trader chose to trade the call spread and (temporarily) ignore the put spread. This is not a sound policy. Why?

- *The call spread was sold as a hedge*. It was sold as a way to reduce losses that may accrue from being short the put spread. It was not sold to generate a profit because the whole iron condor trade is designed to earn money. If you understand this idea, then you understand how to trade iron condors.

- When the underlying asset moves lower, the put spread increases in value and the trader loses money. In addition, that put spread becomes more risky to hold because it is less far out of the money, has a higher delta, and costs more to cover. The rate at which money is lost (if the market continues to decline) increases because gamma for the put spread becomes more negative.

- When the call spread is no longer part of the position, it no longer provides a hedge to (partially) offset losses from the put spread. Thus once the call spread has been covered:

    - Losses accrue even more quickly as the market declines.

- ○ The sum of money at risk is larger.

- ○ There is a higher probability that the trade will be abandoned at a loss.

> **NOTE:** The same situation obtains when the trader elects to cover the put spread in a rising market. The wrong mindset provides a temptation to lock in an imaginary profit on the put spread and sacrifice the advantages of owning a hedged position.

The iron condor trader with a better mindset understands that owning the entire position and not two separate positions represents efficient trade management. The iron condor trader must understand that a moving market is probably going to result in an overall loss and is in no hurry to cover either the call or put spread. As the underlying price moves nearer to one side of the iron condor, that side loses money more rapidly than the other side gains. However, as long as that 'other side' is not priced near zero, it acts as a position hedge and reduces overall losses. That is the reason for not rushing to cover that 'other side.'

To understand how this works, a casual acquaintance with the Greeks is necessary.

CLOSING HALF THE IRON CONDOR

There is a point at which there is no practical reason to remain short one of the individual spreads. When one half of the condor becomes so inexpensive, there is very little left to earn and it no longer provides any hedge. It would take a significant move (or some time to pass) for it to gain another few pennies. Thus, it is best covered. Think of covering as an insurance policy to protect the trader against the possibility that the market could suddenly reverse direction and convert this inexpensive spread into a liability.

Choosing that specific price to exit is one of those individual decisions based on how much cash was originally collected and how much time remains before expiration arrives. For me, the price point for covering a 10-point spread when trading SPX or RUT options is 15 or 20 cents (the original sale price was roughly $1.50). I suggest that you include this ‘buy back’ price as part of the written trade plan.

Note the very important difference in the strategy of covering half of any iron condor. We do not rush to cover when the spread retains enough premium to act as a hedge when the market continues to move in the same direction. We exit when the premium is so low that there is no practical hedge remaining.

EACH OPTION IN THE IRON CONDOR SERVES A PURPOSE

The iron condor trader sells options to make money. We take market risk (big price change) in return for the chance to profit when those options decay and can be covered at a profit or allowed to expire worthless.

The true risk of trading an iron condor (or a simple credit spread) can be described as follows:

> Will we be able to close the whole position with a profit sufficient to justify taking the risk -- before the underlying asset price changes by enough to force us to exit with a loss?

Remember: risk is not eliminated until both the call and put spreads are covered.

The long options are bought for the *sole purpose* of providing insurance that limits losses. In the IBM example, we do not buy the 230 calls because we are bullish. Nor do we buy the 170 puts because we are bearish. We buy them only to prevent a disaster. If the market surges through one of the short strikes (220 or 180) then potential losses are essentially unlimited. By owning the wings (the farther out of the money puts and calls that we bought), the maximumloss is limited to $1,000—less the premium collected when initiating the trade. It is our ability to limit losses that makes trading iron condors a reasonable strategy.

> **Important NOTE: In this context, 'covered at a profit' refers to the whole iron condor. It never means buying back *only* the option sold. It is a poor practice to cover the short options (see Chapter 21) and hold onto the long options (unless those long options are only worth $0.05). The ONLY reason that we bought the wings

is because they limited our exposure to a large loss. They were not bought to earn money; they were bought to limit losses. Once we cover the short option (sold to generate a profit), this 'protective' option is no longer needed and should be sold.

The Winning Mindset

The iron condor is a position with 4-legs. It is designed to be maintained as a position with 4 legs. The winning strategy is to avoid the temptation to cover only the call spread or only the put spread.

I manage this trade as a single position. The only exception is to cover one of the two spreads when there is far too little premium remaining and it no longer acts as a useful hedge.

If I turn bullish or bearish and want to make a directional play on the market, I will make that as a *separate play*. I will not mess with the iron condor position. I may exit because of my new market bias, but I will not buy the short call or the short call spread as a directional play, just because I am suddenly bullish. (More on this in Chapter 21.)

I believe that trading **CTM iron condors** (close to the money) requires a certain way of thinking. It is not for the trader who cannot comfortably hold a position with an ITM short option. I understand that mindset. There is nothing wrong with it. However, if that describes you, avoid being in that situation. Do not sell credit spreads when the short option has a high delta. Begin your iron-condor trading career with 8- to 10-delta options and take your time in deciding how far OTM the short options should be to allow you to sleep at night.

I believe that **FOTM** (delta 2-4) (far out of the money) credit spreads and iron condors offer a return that is far too small for the risk. It is true that these appear to be very 'safe' positions because they are profitable so often. However there are two serious arguments against owning such positions:

- Unlikely events (tails of the curve) occur more often than statistics predict. Such trades get into trouble more often that their pitiful rewards justify.

- It is very difficult to manage risk when the initial premium is small. I'm referring to collecting a credit of 25 cents or less for a 10-point iron condor. Think of how difficult it becomes to pull the trigger and pay $1.00 to exit. To exit at that level, you would be locking a loss that covers profits for four months. How about $2.00? That's where many traders love to *open* their positions. Would you really exit at that price and lose so much on a single trade? Dare you let it ride because there is no exit price that feels right? If you believe that getting out sooner – perhaps when the premium is $0.40) makes sense, you will discover that you pay that low price too frequently, leaving no chance to earn money.

    - One additional problem: If you do exit one side because it became uncomfortable to hold, there may not be anyone willing to sell the other ('winning') side at a low price - perhaps10 cents. You may have to wait for expiration to exit because (trust me) you will not feel like paying 10 cents to get out of the trade. You will feel compelled to hold, in an effort to avoid adding another $0.10 to the total loss. By not being willing to add that small sum to the loss, such traders fail to consider the possibility of a rare event in which the market reverses direction and forces them to exit the other half of the iron condor (with another big loss).

I recommend that beginners with some experience trade index iron condors with one- to three-month expirations and 8- to 12-delta for their short options. However, options with very short lifetimes have become popular trading vehicles. The rewards are so tempting that I must repeat my warning: If you are not experienced in handling positions with significant negative gamma, avoid trading the weekly options until you are very comfortable making risk-management decisions.

New traders may feel more comfortable by being short 6- or 7-delta options.

I use different risk-management methods when dealing with different types of iron condors. Short term vs. long term. Ten-delta options vs. 25-delta options.

CHAPTER 7

WEEKLY IRON CONDORS

I confess. I have a strong preference for trading iron condors. I am comfortable with the risk/reward and believe I can manage the trades well enough to earn money on a consistent basis. Some years are excellent (reinforcing my premise) and others are not (reinforcing the truth: My discipline is good, but not good enough).

I do not recommend iron condors for everyone. It is a good tool to have in your arsenal of trades, but frequency of use has to be a personal decision. Some market conditions can destroy the iron condor trader. Save these trades for times when you truly have no market bias, or better yet, for times when you have a strong belief that the markets are headed nowhere.

When market conditions suggest that iron condor trading may involve higher than usual risk—without an appropriate increase inthe potential profit—it is a good idea avoid trading as usual. Recognizing when these conditions obtain may be difficult for the rookie trader. As a guideline, if you are especially nervous about entering the trade—and the true reason for that discomfort may be unknown—trust your instincts and avoid the trade or open a small (25 to 50% of your usual size) position.

If you do not have another strategy to trade, have the patience to wait for a good opportunity and use the time to learn about or practice an alternative strategy.

RISK MANAGEMENT

Positions with short lifetimes require plenty of attention. If you work full time, it is possible to come home from work and discover that a position has moved near its maximum theoretical loss. If you cannot watch positions frequently, the trade becomes more of a gamble than an investment. The only acceptable defense is to size the trade correctly. That means SMALL size. For those with full-time jobs, the appropriate size for short-term options is probably zero.

Time to expiration is short. The options decay rapidly and a quick profit is possible. That's the good news.

However, gamma changes rapidly. Bottom line: Traders are in jeopardy of incurring a substantial loss over a very short time span.

Trading short-term credit spreads (reminder: an iron condor is a position with two credit spreads) is often a gamble. The trader wins or loses with little chance to make adjustments because choices are limited when time is so short. [Please: Do not roll to another expiration date when trading weekly options, no matter how tempting. The short-term iron condor requires different risk management techniques. Extending your exposure for another week or two is NOT the solution.

THE TRADE

My recommendations, and their rationale, for trading weekly options:

- Before making the trade, recognize:
  - This is FULL TIME trading, despite the fact that we are in the market 2-3 days per week and out 4-5 days. The trader must be able to watch the positions several times each day.
  - Do not plan to earn every penny collected. Exit quickly when target profit (per your written trade plan) is reached. Holding an extra day or two adds considerable risk.
  - Minimize the holding period and avoid weekends. This is a risk-reducing compromise. You miss the extra time decay over the weekend, but you (more importantly, in my opinion) avoid exposure to possible market-moving events.
- Enter the trade early Monday (or possibly Tuesday) morning. Once the market settles down for the day, the premium in these short-term options begins to disappear. Unless the market suddenly becomes more volatile, morning entry gets the day's best prices.

Plan to exit no later than Thursday afternoon. [Some European style index options settle (essentially the same as 'expire') Friday morning at the opening of trading. However, the method used to calculate the final closing price (settlement price) for the index is far different than 'normal' and can result in very surprising (and costly) results. For more information on how these options are settled, see my blog post.]

Check the cost to exit Wednesday (or Tuesday) afternoon. On occasion the one- or two-day profit is good enough and sitting on the sidelines until the following week keeps us out of trouble.

I prefer to exit late in the trading day when possible. Once I accepted the risk of owning the position overnight, I prefer to earn the full day of time decay.

- Be flexible. The options are seldom far out of the money (because they are too inexpensive to sell). Use your judgment and err on the side of safety. There is a lot of money to be made, but only when if the trader is comfortable with the risk, has the skills to manage risk efficiently, and has the time to watch positions.

- The trade plan has a profit. Take that profit when it comes your way.

- You will NOT win every week. Establish a maximum acceptable loss because this is not the strategy for stubborn traders.

Be prepared to adjust by rolling down to lower-delta, farther out-of-the-money strike prices. When necessary, adjust or exit.

Do not hold through expiration. Enter bids to exit the call spread or put spread if and when it reaches your low price ($0.05, perhaps $0.10). Assume you must pay at least $0.15 to exit any iron condor as a single transaction.

When making the trade, collect sufficient premium to cover commissions, the cost to exit, and to provide a profit. Failure to plan ahead may turn 'successful' trades into trades with no profit.

Select spreads with a narrow width. I recommend 5- or 10-point call/put spreads when trading index options.

The Winning Mindset

1) The successful option trader understands this truth: Options are versatile and flexible investment tools. They can be used in a variety of strategies. That trader is not married to a single strategy.

2) The iron condor trader can select from several position types and each is a separate strategy unto itself. Each requires different risk management and exit techniques. Some personality traits make it easier for a trader to adopt one style of trading as opposed to another.

3) Weekly options are quite different from their longer-term cousins. Their value disappears quickly. However, they can become expensive even more quickly, and without a giant market move. These short-term options present too much risk for many traders.

PART THREE

The Greeks

CHAPTER 8
THE GREEKS

This short chapter is included because it is very tempting for newer option traders to ‘skip over the Greeks for now’ with the intention of paying attention to them later. That is not a winning mindset.

The Greeks are used to measure risk. That is all they do. Understanding just how much can be earned or lost from every position in your portfolio is important. Recognizing what has to happen in the marketplace for your positions to perform well is mandatory because your positions should reflect your market expectations. Being aware of the market action that sends the value of your portfolio into a tailspin is also valuable information because you want to know when to take action to protect your assets. When you own positions and the market does something surprising, it is not wise to sit tight and “see what happens.” When a trader knows what to expect in terms of gains or loss, that trader is well placed to lock in profits or minimize losses.

The Greeks is not a complicated topic. Of course, you can undertake a complex and detailed study of the Greeks. However, there is no reason for the newer trader to get bogged down at this point. There are benefits to gaining a deeper understanding, but please don’t skip a basic introduction to the Greeks.

RISK MEASUREMENT

When markets move, or fail to move, option traders earn or lose money. I think we all understand that. However, if you know just how much money you may make (or lose) when the market does certain things, then you will have much more confidence that you know whether the positions in your account are within your comfort zone. For example, a trader wants to have answers to these very basic questions:

- If the underlying stock moves up or down by two points over the next week, how much does that change the value of my position?

- If I own call options, how much money can I hope to earn if the underlying asset moves higher by 3% over the next two weeks?

- Can I afford to own 10-lots of this position? Would that be placing too much at risk?

- If I open a credit spread, how quickly will I make (or lose) money if the stock moves in the right (or wrong) direction?

This is not complex. No mathematical calculations are required, other than addition and subtraction. Calculators do all the work and supply the numbers. Your job is to interpret the numbers.

It is worthwhile to gain an understanding how the Greeks work.

The Winning Mindset

If I want to have any chance of managing risk effectively, then I must spend a little time reading about the basic Greeks. Those include: delta, gamma, theta, and vega.

CHAPTER 9
TIME DECAY (THETA)

FOR THE OPTION SELLER

Warning: Time decay can be a wonderful thing for the option seller. In fact, it is the driving force behind the so-called 'income-generating' strategies. The trader holds a position, waits, and then exits with a nice profit. When the position is market-neutral, and when the market behaves, all gains can be attributed to the magic of time decay.

- Positions with that positive time decay are subject to losing money when the underlying asset does not behave as anticipated. These losses are directly related to negative gamma [the Greek that measures the rate at which delta changes. Negative gamma makes the position longer (more bullish) as the market falls and shorter (more bearish) as the market rallies]. For our waiting period to prove profitable, it is necessary for the market to 'behave.' Translation: The market must not stray too near to the strike price(s) of the options that were sold.

- For positions where the short options have only a single strike price (calendar, butterfly, credit spread), the underlying must remain near, or move towards that strike price for maximum profit. There is leeway, but losses occur when the underlying moves to far from that strike.

- For positions with two such short strikes (condor, for example), the underlying must remain between those strike prices (preferably not near either) for the waiting period to be successful.

FOR THE OPTION BUYER

The opposite is true for the option owner. When owning an option, the trader has the potential to score a big profit—if the underlying asset makes the anticipated move. However, options are wasting assets and lose value each day. For the option owner, the passage of time is a negative factor and once the option is bought, the desired price movement must occur before the option expires, and the sooner the better. Note that the underlying does not have to move to any specific

price when your plan is to sell the option well before expiration (recommended).

> The idea is to sell the option when its price has appreciated by enough to deliver the desired profit.

Too many option owners make the mistake of buying options and holding all the way to the end, thereby sacrificing every penny paid for time premium.

RISK MANAGEMENT

And that's the problem. Waiting for options to decay is 'easy,' but can be a risky proposition. In the real world, things are not simple. The underlying stock or index may approach the strike price of your short option(s). That can be a frightening situation—especially for the rookie trader who is experiencing this for the first time. The natural—and appropriate—reaction is to relieve the fear by reducing or eliminating risk.

- Being willing to take that defensive action is an essential part of managing risk for these positive-theta (time decay is on your side), negative-gamma trades. When things go well, traders who hold positive theta positions can make a good living. However when markets become volatile or unidirectional, losses can accumulate quickly. To survive, the trader must become a skilled risk manager.
- It's a fine line between getting out of a position that has become too risky to own and holding onto the trade for a little longer, looking for a market reversal.
- The biggest difficulty for the rookie trader is to avoid adopting this mindset: "The market cannot move any more in this direction. Look how far it has come already. I know there is a reversal coming very soon." That thought represents a financial death wish.

Believe me, it is an easy mindset to develop. We always prefer to believe that we made good trade decisions and that our trades will work out well in the end. That is confirmation bias. And perhaps these will become profitable when all is said and done. However, the *risk* of

substantial loss has become high; too high for the disciplined and successful trader to take the risk of waiting. He knows that something bad may happen and that the happy ending may never be seen. For example, it is not uncommon for a stock rally to 'squeeze the shorts'—only to fall back to earth. That happens. But why take the risk? Why put yourself in position to take a big loss?

- The proper mindset is: "I don't know whether the market is moving higher or lower from here. I have a bias, but I just cannot afford to take that chance. I'm going to get out of my risky trade and take the loss. I will survive to trade (and prosper) in the future. If I want to place a wager on my current market bias, I can find a far better way to make that play than holding onto my current (money-losing and risky) position."

- During a discussing on position management, one trader offered the following: "Theta is how I track my progress for any trade."

  I get it. We watch the value of our account grow steadily. We watch the price of the short options move toward zero (or the price of the spread we own increase in value). It is so easy for new traders to believe that they discovered the Holy Grail of trading.

  That euphoria can go on for a long time. Please remember:

- There is no free money. All trades involve risk. A winning streak can end suddenly.

- Theta is the trader's REWARD for another day passing with no relevant consequences. Translation: Theta is the reward for taking risk and owning the winning side.

- Yes, you can watch the profits accrue day after day. There will be periods when the trade plan (hold and wait) works perfectly. That is not as beneficial as it seems because it may bring unrealistic (and dangerous) expectations, such as falsely believing that trading credit spreads is far too conservative and that there is so muchmoney to be made by selling naked options. When the trader does not buy father OTM option to complete the credit spread, the net premium collected is

significantly larger. That increases profit potential. The difficulty is that risk has grown enormously—because losses are now essentially unlimited. Someone who has not lived through a violent market can go bankrupt in a heartbeat. That less-experienced trader often brushes aside all warnings because those volatile markets represent something he has never seen.

- As you watch the days pass and profits accumulate, it is easy to lose sight of the fact that risk (defined as the amount of money that can be lost from your current position) has increased. The factor that changed as time passed is that the probability of incurring that loss is now smaller.
- It only takes ONE bad day to kill the profits from weeks of collecting theta. Translation, as you continue to wait, a two standard deviation move (expected about once every 20 trading days) could turn your winners into losers.
- When a trader watches an account grow every day, he becomes blind to risk. Trust me. I have been in your shoes and watched positive theta grow my account. Then I watched as theta's Greek counterpart (gamma) withdrew all the profits, and more, from that same account.
- Warning: Recognize the danger of being mesmerized by profits. Risk is not diminished as time passes. The probability of losing has decreased, but that is not the same thing. The chance of losing does not reach zero until expiration has passed or the position has been closed.
- Please be aware of risk. Do not grow overconfident. Time decay is your friend, but it is not your savior. Owning positive theta positions can be a very profitable strategy. The warning is to be certain that you never fail to recognize just how much money can be lost from any trade.

The Winning Mindset

"I know my risk at all times. I manage positions to earn money, but more importantly to maintain risk that is well within my ability to absorb any potential loss."

Takeoff of Pete Seeger's song adapted from Ecclesiastes:

To everything (turn, turn turn) there is a season (turn, turn, turn)
A time to sell premium and a time not to sell it
A time to sell theta and a time to own gamma
A time to collect daily decay, and a time to avoid it.

To repeat: A proper mindset involves accepting that you do not know whether the market is moving higher or lower. You may have a bias, but cannot afford to risk holding onto high-risk positions. You will the risky position, take the loss, and survive to trade (and prosper) again. If you want to place a market wager on your bias, find a far less risky trade.

PART FOUR

Mindsets that can be Changed

CHAPTER 10

WHAT CAN I EARN AS A TRADER?

Over the years the single question that I am asked most often is: “How much can I expect to earn when using options?”

I understand the thought process behind the question, but it always disturbs me. It’s the wrong question to ask. I would have much more confidence that the new trader is on the right track if one of these questions were asked instead:

- How much time should I plan to devote to my options education before I can anticipate earning any money?
- How much cash do I need before opening an option-trading account?
- Do most new option traders find success? Or do they tend to give up?
- I’ve never traded stocks or anything else. Will that make it difficult to learn to trade options?
- Is it worthwhile to learn to trade options or should I pay a professional trader to trade for me?

These questions demonstrate that the person who wants to become an option trader recognizes that this is not a gimmie, and that some time and effort must be expended before rewards can be earned. The commonly asked question: ‘How much can I earn?’ suggests that the person asking ‘knows’ success is easy, and that the only thing holding him back from joining the game is wondering whether it’s worthwhile.

I seldom, if ever, receive a question along these lines: ‘What does it take to succeed?’ It’s always similar to: ‘I’m going to succeed. How much can I make?’

A READER’S LETTER

Below is one sample letter from Jo:

> Hi Mark,
>
> Is it possible for an ordinary person to generate income from trading options if they are able to sustain themselves for a few months without a job, while learning the ropes? How much can one hope to earn through trading options on the conservative side, and how long does it take to become an expert on average?
>
> Is it necessary to purchase special software for options trading (technical indicators and such)?
>
> Thank you,
>
> Jo

These are thoughtful and optimistic questions.

Is it possible?

Yes. It can be done. You can generate income. Apparently you are seeking to earn a living by trading instead of looking for employment. Please be aware of one important point: There is a great deal of pressure on the investor/trader when money is 'needed' for living expenses. Learning to trade requires time to study, practice and grow into the business. That added pressure often leads to poor trade decisions. I'm sure you understand. And that's why you plan to have 'a few months' cash in reserve. That's an excellent beginning. I'd prefer to see you have enough cash set aside for six months.

The good news is that you recognize that profits do not begin from day one. The not so good news is that you are asking whether it's reasonable to *learn enough* to make a living—during those few months. The first answer is that every student has a different ability to learn and some just have a better aptitude for options and can work more quickly than others. So yes, it is possible to produce earnings within that time slot. But not everyone can move as quickly. And of course, not everyone can do it no matter how much time and effort they spend on an education.

One reason for that is the general cautiousness of people. It's a good

idea to begin trading with a small number of dollars at risk. In fact many start with a paper-trading account and continue with that for many months. You would not have that luxury because you would have to get in some useful practice, and then trade with small money. After that comes gradually increasing position size and taking on more risk. Why must you do that? Because you are not looking for supplemental income; you want to earn a living, or earn enough to make a significant contribution to your monthly needs. Thus, your earnings goal cannot be too modest.

- Yes Jo, you can do it. If you have the patience. If you take the time to learn and are not rushed into trading. If you have or can develop the skills. And if you have sufficient capital to give yourself a realistic chance.

- Achieving success as an investor can be very rewarding over the years. It is easier to accomplish when you have the comfort of a full-time job and the income that it provides. Trading full time requires a different mindset.

Therefore, you need at least $3,000 per month (for very modest/frugal living) or much more if you are anything other than a new college graduate who can live cheaply while developing trading skills.

It is not that $3,000 or $5,000 or $10,000 per month is not an achievable goal. However, it is not the total dollars that you want to earn that matters. The really important question is *how much money can you deposit into your trading account?* When using options, we tend to own positions for much longer than one day, and that means we must meet margin requirements. In turn, that means we must have some capital before we can own positions. Margin is a deposit, required by the SEC and your broker to own certain positions. Think of it as collateral that protects your brokers from losing money.

If you open an account with $20,000, I hope you understand that it is almost impossible to generate $5,000 per month. That would be a return of 25% in one month. Yes, you may do that well during your trading career, but only occasionally. In fact, unless you are willing to take on a lot more risk than is advisable, you should not expect to earn even 5% per month. Do not misunderstand. Five percent per month is a huge return. Earn that return every month for two years and you would convert $1,000 to $3,225. Wouldn't we all like to triple our net worth every couple of years?

It takes money to make money, and that is one of the obstacles that is

usually unrecognized upfront. Even when a trader has access to funds, it is very likely that the money would have to be protected against loss and that means the trader would use more conservative strategies with smaller potential profits.

- The answer to your question is that you can make a lot of money. However, you must have a good-sized account balance to do that. I tell new traders that it is a reasonable GOAL to shoot for 20% per year. Please read the words carefully. That is per YEAR. It is also a GOAL. It is a good target. *However, do not believe that it is an easy target to achieve.* Do not believe that you can earn that much on a consistent basis. The bottom line is that if you have an account worth $100,000, it may not be anywhere near enough to generate sufficient income to meet your needs. I would consider earning $15,000 on that $100,000 to be a good year for most traders, most years. Yes, you will do better during some years. However, you will almost certainly fail to earn that 15% return much (if not most) of the time.

    - Bottom Line: If you adopt strategies that require a holding period (and that includes the common strategies that I recommend: condors, butterflies, calendar spreads, credit spreads or debit spreads) even $100,000 is not anywhere near enough money for you or me, or any trader to expect to earn a living.

- If you trade high risk strategies, you have a chance to earn a large return on your investment (10+% per month), but that comes with a *very high probability* of going broke. Yes, not just a loss, but a complete blowing up of a trading account. High rewards are usually the result of accepting high risk. Please recognize the subtle difference:

High risk provides *an opportunity* to earn a large reward.

High risk DOES NOT promise large rewards.

There is a very big difference.

- The more conservative trader may seek ‘only 2-3%’ per month. That’s a very good return, but it provides only $2,000 to $3,000 per month on an account valued at $100,000. Most professional traders cannot earn that much. Brett Steenbarger(Psychologist, trading coach, trader and blogger) once told me that the best professional traders earn ‘in the low (*emphasis on low*) double digits’ per year. That assessment sounds right to me.

Going by the above opinion and based on my experience with newer traders, earning 1% per month is a realistic target.

Thus, this is the most important question for deciding when you can get started: How much cash do you have for trading? Most people assume they should target earning a specific number of dollars, rather than a specific return on their investment.

Also consider this: When you begin with a small sum, the risk of ruin, or the probability of going broke, is very large. When you have extra cash, you can withstand a string of small losses and still stay in the game.

Also: When you have a small account, if you have outstanding success and double the account value in one year, the total dollars earned is small. It does take money to make money.

If you have $10,000 and do an excellent job and earn 2% every month, that’s a grand total of $200/month. That will not take you very far. I assume you would want to earn a minimum of 10 to 20x that amount. That is unrealistic. There is a chance that you could have a nice winning streak and quadruple your money in a year or so. But the most likely outcome of seeking such huge returns is the loss of all your capital. The two major requirements for getting started are having a sufficient bankroll and a sufficient education.

THE EXPERT TRADER

Experts are few and far between—assuming that by 'expert' you are referring to someone who knows how to make money and then actually makes it and keeps it. The expert has a deeper understanding than other traders. With that definition, few are experts. The good news is that there is no need for you to become an expert trader. Your goal is to earn a living. If you achieve that goal, then your own talents will tell you whether you should seek to become an expert.

Trading is a game in which you are continually learning. And that's important because markets change over time and if you never change or develop new ideas, you will not remain a successful trader.

On average it takes forever to become an expert trader. The vast majority never get that far. Don't let that upset you. No professional basketball player has to be as good as Michael Jordan was. Good players can achieve success and win championships and earn a huge living.

You do not have to become an expert trader. Being 'good' is good enough. Your objective is to earn enough to meet your needs. If you understand the basics, if you grasp the strategies and know when to apply a couple of them, if you have the discipline, and if you have the bankroll, then you can do very well.

It is true that I would expect the expert to earn more than the 'good' trader. But the bottom line for future earnings still depends on how much money you have for trading and how much risk you want to take. Being conservative and preserving your capital is a splendid idea. Just be aware that being prudent does limit your earnings potential. I support the conservative approach. I don't believe we should risk our bankrolls to make more money. Option trading can be boring. Well, boring is good. Boring is profitable.

To succeed, you must understand what you are trading, and that means taking time to learn option basics. You should have no trouble understanding that options are different (better) from other trading vehicles. For one thing, options come with built-in risk-management tools: The Greeks.

If you are brand new to trading, there is even more to learn, including basic things such as how to enter an order, how to use your broker's trading platform, the different order types (market, limit, stop etc.). Someone with stock trading experience is already familiar with those

items. That may appear to be an advantage because it cuts your learning time. However, if you are just beginning, you have no bad habits to unlearn, and that's a good thing.

DISCIPLINE

You did not ask, but in addition to how options work, the trader must possess (or be able to develop) certain personality traits. Jo, if you are willing to learn how options work, and if you believe you can demonstrate the traits listed below, then you may very well be able to succeed. Not everyone can do it.

Anyone can trade. Anyone can enter the arena and place an order. But to have a chance of making money on a consistent basis, the trader must have:

- Discipline.
- The ability to recognize risk. That means knowing how much money is at stake for every position and understanding the probability of losing money.
- Patience to learn before trading.
- Patience to practice what you have learned, usually in a paper-trading account.
- The ability to control harmful emotions. Fear leads to panic, which results in terrible decision making. Greed has traders taking too much risk for too little reward. Pride encourages traders to refuse to take a loss and/or get out of a bad trade.
- The ability to recognize that a few successful trades does not make you a star trader.
- An understanding that traders cannot earn money every month.
- The ability to recognize that a 90% chance of winning means there is a very real 10% chance of losing.
- Acceptance. Believe that you will not make much money when your bankroll is small.

- An understanding that stock markets live in a statistical realm. Translation: luck plays a role in your performance. However, the skilled risk manager protects the portfolio when the unlikely event unfolds.

TECHNICAL INDICATORS

I never use technical indicators. I know that some traders are very skilled in doing so. But they did not learn overnight, and anyone who tells you it's easy to read charts and make money from the signals is not telling the truth.

I use no trading software, other than risk management software supplied by my broker. If you prefer to use software for the purpose stated in your letter, I offer no objection.

I suggest getting started by reading and attending free seminars offered by the option exchanges or your broker. It may be easier if you take a course. However, these tend to be very expensive and you never know whether the mentor/teacher is qualified to help YOU learn.

Plan to spend some time in the education mode, especially if you set a few months as the time limit. There's no time to waste once you quit your job. I wish you good trading.

The Winning Mindset

I will not rush into trading. My education comes first.

I will not attempt to trade options with a tiny bankroll. $10,000 should be enough for the casual trader. Yes, I can get by with less, but the task is more difficult. If I expect to earn a living, I need at least $200,000.

I do not anticipate success with little effort. Trading requires knowledge and skill and I will acquire knowledge and practice to develop the skills.

I want to earn money. However, I know that I should think of my earnings in terms of a percentage return on my bankroll, and I will not target a specific number of dollars.

CHAPTER 11
TRADING TO RECOVER LOSSES

"Mark,

I am unhappy with a trade and want to recover some of the loss. Two weeks ago I bought 500 XXXX Sept 22C @$0.15. The stock is $13.30 and these calls are heading toward zero. I had a fairly bullish short term outlook for the underlying but it recently stalled.

What I want to do is to sell puts in equal dollar amount to neutralize the loss on this trade. That is where I thought you might come in with some good advice.

A complete loss on this trade is not a game changer for me—more pride than anything. I was dumb to buy such thinly traded contracts.

Thanks in advance,
DL"

Good question. If buying 500 calls (yes, it is only $7,500) is *fairly bullish*, how many do you buy when extremely bullish? (That is a rhetorical question.)

I see no problem in buying thinly traded options under appropriate circumstances. When thin options are at- or in-the-money, they tend to be more liquid – because they become a stock substitute (i.e., you can hedge the position at any time by trading stock.)

However, buying OTM options—already a large gamble—becomes an even bigger problem when you decide to sell. The only buyers are the

market makers, and there is no guarantee that any of them will make a decent bid. They know the open interest, and they recognize that when one individual holds all, or almost all, of that open interest, they have you at their mercy. Why? Because no one else is interested in buying these calls. I note that the strike price is $22.50 and that the stock is $13.30. This stock may have stalled in its rally, but did you really believe that buying options that are so far out of the money would ever be profitable? Why not buy an equal dollar's worth of the call struck at $15, if you were very bullish?

At other times, it could work to your advantage to own thinly traded options, but that only occurs when the people who sold the options are anxious to get those shorts out of their accounts. You may become the only seller of these options and buyers must come to you. But that is a rare event. However, the market makers are probably the ones who sold these thinly-traded options. That means that they have you over a barrel and that you have nowhere else to go to sell your calls.

If these calls were ITM, that would be a different story. You would be able to short stock (up to 50,000 shares) against the calls, locking in a profit (when the stock is above $22.65; strike price plus premium paid).

Thus, trading the thin options was not dumb (in my opinion). But taking a big (for that stock and its daily option volume) position in *out of the money options* was the part of the trade that makes it bad. I understand that you were bullish, but what was the stock price when you bought the calls? Right now these options are hopelessly out of the money. You were looking for a big move in a very short time. Believing that this type of move is possible is what results in traders buying options with an inappropriate strike price.

HERE IS MY PHILOSOPHY

When you earn money, the dollars spend the same, regardless of which stock produces those profits. Do not feel compelled to earn money from XXXX. Translation: Do not do anything foolish in an attempt to recover the loss. Accept that this is a losing trade and chalk it up as a lesson learned.

SOME THOUGHTS ON YOUR SITUATION

I know you want to sell put options to collect enough cash to partially offset the loss from buying the calls. However, there are two big problems with that idea.

First, it is too late. Time is very short (one week to expiration), and it is not easy to collect any reasonable premium by selling OTM put options. If you sell puts that are only out of the money by a small amount, you face big downside risk. Such risk should only (if ever) be taken when you are confident that the stock will move higher. You have no such opinion and selling puts would be a big mistake.

Second, the stock must rally by more than 60% to move the calls into the money. These calls provide zero hedge (because they are already essentially worthless), so any puts sold would be essentially naked short. Selling those puts places you in jeopardy of suffering a gigantic loss.

You may be able to sell Sep 22 12.5 puts. They are OTM, but the most you get for those is $0.05 – and you may not be able to get that much when selling. Collecting five cents per option represents too much downside risk for the reward. We both know that these puts are very likely to expire worthless, but I believe you can find better plays (in a different stock), with appropriate risk/reward potential. This is not a good choice.

Selling the Sep 20 puts would be better – but there is little chance of collecting five cents – and to be honest – I still do not like the idea of risking your money for such a small reward.

I see your choice as coming down to two:

- Enter an order to sell your long calls at 5 cents. There is little chance that anyone will buy them.

- Hold and hope for a miracle. I'm not a fan of depending on hope. But this trade represents a lost cause. Take the $7,500 loss and move on.

You can consider moving this play beyond the Sep 22 expiration date. But please – do not make this trade as pride recovery. Do not make it to 'get back' some of the loss. Do it ONLY if you still want to maintain a bullish position *and if this trade* is appropriate for you.

OTHER POSSIBILITIES:

Sell Oct 10 puts at 15 cents. DO NOT sell 500. DO NOT try to 'get even.' Do this ONLY in an attempt to earn SOME money from a position that you are *eager* to own. The sale of 50 puts may be too many because you could find yourself owning 5,000 shares. Size depends on your comfort with the trade and whether you are willing to be short puts. Think of the downside risk when choosing position size.

Sell (be careful with position size) Oct 12.5 puts at 40 to 50 cents. Do not think in terms of collecting $7,500. Think in terms of how much can be lost if the stock falls out of bed. With the bid for this option so low (25 cents) and the bid/ask so wide, we do not know how much the market makers are willing to pay to buy these options. Demand a higher price than the bid. These thin options can trade very strangely because you never know the true bid or ask.

Maybe you can sell the Oct 10/12.5 put spread. Spreads are a problem when options are thinly traded. You have to anticipate being forced to hold to expiration. You want a GOOD price to make this trade, knowing that lack of liquidity will become important if you ever want to adjust or exit the trade. I suggest 30 to 35 cents. Sure, you can accept 25 cents, but at some price the risk will not justify the potential gain. Again, that is something for you to decide. It does depend on just how bullish you choose to remain. Warning: It is easy to sell too many spreads when losses are limited. [The loss may be limited, but the chances of losing the maximum are far from zero. It is common to become frozen and unable to act when a trader has a position that is larger than he can handle and trouble looms.]

Bottom Line: If your 'short-term bullish outlook' has expired, then do not trade this stock at this time.

The Winning Mindset

I never force the sale of options. I never make a trade just to 'do something. ' I never make a trade out of boredom. If there is no trade that suits my needs – and my need is to open a position with numbers that I like: maximum loss vs. potential profit, combined with the probability that my short options will not 'get into trouble.'

Translation: The shorts remain far enough out of the money so that I remain comfortable owning the position. There are no specific numbers associated with getting into trouble because each individual trader must define the borders of his own comfort zone. I know there will be plenty of opportunities in the future. It may be tempting to 'make a few extra dollars' by selling far OTM options and watch them expire worthless, but risk is too large for the tiny reward, despite a high probability for success.

When bored, I take a break and walk away from the market for a while.

To DL: I must reemphasize that selling naked options can result in a large loss. You must have an acceptable return in exchange for taking that risk. I do not recommend selling naked options. The only exception: It is acceptable to write cash-secured puts when the trader wants to accumulate shares at a price below the current market.

Selling options and collecting $0.05 or $0.10 apiece is a losing game over the longer-term. Please remember this: You spent $7,500 on calls. When selling puts, you would sell so few that the dollars earned would barely dent that loss. Don't do it.

Important mindset: When I lose money, I never believe that the specific stock or index 'owes' me anything and I avoid the trap of seeking revenge. My objective as a trader is to earn money. The net liquidation value of my account does not know the source of profits. Nor does it know which trades resulted in losses. All dollars earned spend the same. I let the losses go and seek a better trade – when I'm ready.

'Hope' is not a strategy.

Trading limited loss strategies requires recognition that the possibility of incurring the maximum loss is real.

I enjoy the reduced risk of trading limited loss strategies, such as: credit spreads, debit spreads, iron condors, butterflys, calendars, diagonals etc. I've learned to avoid a blind spot that traps many rookie traders: A trade may have a limited loss, but traders must not own a position that is too large. Losing the maximum possible amount is something that is going to happen on occasion, no matter how careful you are in managing risk.

EXAMPLE:

You are willing to buy $15,000 worth (200 shares @ $75) of stock and understand that it is possible, but very unlikely to lose that $15,000. Losing even half that amount is very unlikely.

When you sell an October 70/75 put spread, collecting $150, it is possible to lose the maximum ($350 per spread). Do not make the mistake of selling 20 spreads when your alternative is to buy only 200 shares. The 20-lots can result in a $7,000 loss (20 * 350) and that is far more likely to happen than seeing the stock price get cut in half.

Trade size is important. If you want to buy 200 shares, then trade two of these put spreads. Do not trade larger size. That is a trap to avoid.

***THIS MINDSET ALSO APPLIES WHEN EXITING A TRADE

If yesterday would have been (looking back) a good time to exit because some of my gains have gone away today, I accept that fact.

Yesterday I elected to hold the position and target an even larger gain for reasons that were appropriate yesterday. Today the situation has changed and if I believe that it is a good time to exit, I exit. I do not dwell on the fact that yesterday would have been better. I must deal with the situation as it exists today.

It has been demonstrated that people believe that losing money feels far worse than missing an opportunity to earn the same amount. It just hurts more once the money belonged to you.

Yes, I may have lost an opportunity by waiting overnight, but there is nothing I can do about that. My job is to make good decisions today.

CHAPTER 12
BEING RIGHT VS. MAKING MONEY

The successful trader does not assume that once a profitable approach to trading has been discovered, all he/she has to do is implement that strategy and practice sound risk management. Times change, market conditions change, the trader's financial obligations change, etc. Each of these (and other) factors plays a role in deciding how we trade. It's important to be aware of the bigger picture when deciding which strategies to adopt.

It's obvious, but when you marry, raise children, buy a house, plan to pay for college or retirement—your financial needs change. You probably don't want to continue trading as you did earlier. More responsibility suggests a less aggressive behavior. Being aware of this is part of the mindset required for success. Know where you stand in planning for your financial future. That will go a long way toward helping you decide how to choose trade strategies, position size, how aggressively to manage risk etc.

This simple, not-repeated-often-enough truth, from a blog post by The Crosshairs Trader was the driving force for putting these ideas into words:

Successful trading is about making money…not about being right.

It is not easy for traders with an incorrect mindset to focus on making money. There is a lot of ego satisfaction that comes with having made a solid and accurate prediction. However, if your goal is (as it should be) to grow your account while taking an acceptable level of risk, then it is more important to recognize when you are wrong so trades can be closed and larger losses avoided. It is more important to make money than to be right on any specific percentage of your trades.

If you accept that as true, then be certain you are making trade decisions based on an appropriate mindset. As an example, I recently recognized that a new way of looking at one specific situation would be beneficial, even though it represented a complete change. I have

not discarded that mindset. It remains near the top of my trading beliefs. However, other factors came into play which made me recognize that even the most cherished beliefs can be put on the shelf temporarily – for the right reasons. And who knows? Temporary may become permanent.

FIRST A LITTLE BACKGROUND ON MY MINDSET CHANGE.

During my career as a CBOE market maker, I stubbornly refused to cover short positions when they reached the minimum trading price of 1/16 ($0.0625). I wanted to earn those last few pennies and always allowed these short options to expire worthless. The more success that I had, the more it appeared to represent free money. To make a long story short, I earned lots of money via this strategy. However, when the market moved against those shorts, and when the move was sudden and violent, the losses were spectacular and easily wiped out all previous profits.

After repeating that debacle (more than once), I finally got it: Cover those cheap short positions and let someone else have the last few pennies. What a difference that has made! That is why I preach the idea that giving up the last nickel or two on any trade is a worthwhile risk management technique for option traders.

It is easy to extend my eye-opening revelation. If it is not right to hold short options through expiration, it is right to exit all high risk positions as expiration nears. Thus, I moved away from trading shorter-term options. In those days, one-month options were the shortest duration. When options with a weekly expiration were introduced, it was easy to avoid them on the simple premise that they had too much negative gamma and that it would be better for my personal comfort zone to avoid such options.

Note: Weekly options are very popular and are appropriate for traders who recognize the risk/reward potential – and who will take defensive action when necessary.

That worked for me. However, as an options educator, it is not right to subject readers to that personal bias. Thus, I began to look into trading shorter-term options so that I could hold serious discussions on which strategies to adopt when trading weekly options. I am still gun shy of negative gamma. I still issue warnings about how much potential risk there is when trading short-term options, but the truth is that I also write about the attractive reward possibilities.

So, I've made the mindset change. It used to be: Do not sell options when they come with significant negative gamma.

Now I think this way: Be cautious when trading short-term options. They come with high negative gamma and that makes them inappropriate for some traders. However, the rapid time decay makes them attractive to a different group of traders. Even with weekly options, do not hold positions to expiration. Cover all shorts at an appropriate low price. Do not trade the weekly options as a habit. Make a decision–each time—as to whether current conditions make the trade appropriate. Some market conditions (volatile or trending markets) are unfavorable for premium sellers.

The basis for this mindset

- Both buyers and sellers are subject to high gamma and high theta. That is just too much risk for my personal trading style.
- When a position has large gamma, the value of any position is subject to a big and *sudden* change. As a result, the trader could earn (if he/she has positive gamma) or lose (negative gamma) a lot of money *very* quickly. [Positive gamma is the rate at which your position gets longer on a rally (equivalent to buying more shares) or gets shorter (equivalent to selling shares) on declines. If you are not familiar with the Greeks, please take the time to do a little reading on the topic. For now, the important thing to know is quite basic: Greeks allow traders to measure risk. When risk is too high, we can make appropriate risk-reducing trade adjustments.]
- Theta describes how much the value of an option changes as one day passes. We earn (positive theta) or lose (negative theta) significant money when we have a position that is near expiration and the price of the underlying does *not* undergo that big change.

Either way—long or short—these options were not for me. I prefer less risk. End of story. I had a closed mind(set). However, I cannot allow my personal bias to get in the way of providing a solid education for all readers. So I set it aside and began experimenting with weekly iron condor trades.

We must understand the advantages and disadvantages of trading short-term options. Only then can any trader make a solid decision about trading, or avoiding, them. My results were mixed. Profits were

earned early, but then it became a losing proposition when the relatively small premium proved to be insufficient to pay for needed adjustments. Near-term options are for disciplined traders who have the will power to do what they know is correct.

THE NEED TO BE RIGHT

Here's the exaggerated rationale for avoiding covering cheap short-term options. Please understand that this is the thought process of a trader who is unlikely to find success:

"I could have paid 5 cents to exit this trade and lock in my profit, but refused to do so. I know this option will expire worthless.

I could have paid 10 cents just a few hours later. It still does not matter because these will soon be worthless.

The next morning it would have cost 40 cents to get out of the trade, and there was no way that I would pay that much. Plus, there is no reason why I should. I know it is not possible for the stock to move that far that quickly.

Today, it's $1.00 per option to exit. In other words, I am worse off by $95 per option. I don't want to make that trade. However, maybe I can get lucky. These options are still two points out of the money ($100 stock price), so I am not yet in REAL trouble. Yes, I admit that I now see the *possibility* that I was wrong, but I'm not going to pay $100 per option."

This situation is the very definition of *real trouble*. If the stock moves a few more points, it could easily cost that trader $400 per option to exit. Even a 10-lot would result in a $4,000 cost, when the trader could have covered the whole position for $50. This is true trouble, and when the trader denies that it is a problem because 'the option is still out of the money,' then this trader is not thinking logically. This trader is not managing risk. This trader is blind to big trouble and is not likely to survive over the longer term.

Refusing to pay more than you could have paid earlier is not risk management. It is insanity.

AVOIDING TROUBLE

One way to stay out of trouble and avoid the situation described above is to cover (buy) your short options positions (spreads or single options) when the price is attractive (i.e., inexpensive). Do not hold to expiration. Do not seek the last nickel or dime from the trade. Take your gain, and get out of a potential (even if unlikely) large loss. That is the winning mindset.

Adopting that way of thinking convinced me that trading all near-term options is a risk not worth taking. A closed mind kept me out of trouble.

When we have a market bias—bullish, bearish, or neutral, we WANT to be right. The obvious reason is that we make money when the market does as we anticipate. And that's a doubly good feeling. We not only have the profits, but we also have the ego gratification that comes with being 'so smart.'

However, when the market does not behave as you expect (and you know that will happen), it is mandatory not to take it as a personal insult. The 'market' is not out to get you. What the market can (and does) do is trap the stubborn (undisciplined) trader. When you are wrong, that should be the end of the story. Exit the trade; take the loss; live to play again and reconsider your bias.

It sounds so easy. However, it is difficult for many traders because it is contrary to human nature. If we refuse to accept the loss as punishment from an angry market, and if we recognize that statistical calculations represent the truth (if our inputs are accurate), then we know that the market will not do as expected all the time. We know that a 99% probability means that you can expect to lose one time out of every 100 trades.

Traders know that they cannot earn a profit from every trade. They know losing trades are inevitable. Yet, each individual losing trade becomes its own battle: Good risk management (common sense) vs. the need to be right (stubbornness). It may even be recognized that the trader does not have a true 'need' to be right *this time*, but he strives for it anyway. This is not the mindset of a successful trader. In fact, exiting the trade, cutting risk, accepting reality (this trade is a loser), is being right. It is not being right about earlier expectations, but it is being right *now* (when it is far more important). It is okay to

admit being wrong about an expectation.

Our true need is to make money over time. Traders do not have to win all the time. Traders must know when to take losses.

Our true need is to prevent the large losses which hinder our ability to continue as a trader. Many traders lose their entire trading accounts, never to return to the game. The winning mindset is to be aware of that possibility and to trade accordingly. That means we must trade appropriate position size and consider how bad things *can* get for each trade.

Our true need is to practice disciplined, but not rigid, risk management.

ADAPTING TO THE CURRENT MARKET

The current (mid to late-2012) market (generally rising over the past 12 months) makes it difficult for traditional, market-neutral, iron condor traders. To stay ahead of the game and have any chance to make money, the trader would have to make some change to his/her normal methods.

Consider the trader who **adjusts in stages** and plans to cover 20% of the short call spread when the market reaches a specific price level. To accommodate a bullish bias, the trade plan could encompass the idea of initiating the trade with a Stage I adjustment already in place:

EXAMPLE

Assume the usual (iron condor) position is short ten 15-delta put spreads and ten 15-delta call spreads.

Instead, the new trade could be: Short ten put spreads and *only eight* call spreads.

This is equivalent to making a Stage I adjustment (buy back two call spreads) at the time the trade is initiated.

Another idea is to sell call spreads with a smaller delta than the put spreads. That delivers less premium, but it is similar to a position in which the call spread has been covered and rolled-down to another call spread that is farther out of the money.

The Winning Mindset

Forget about being right. Forget about bragging rights. Make money and take care of yourself and your family.

I do not believe in rigid rules that govern trading. However, there are situations for which adhering to a rule makes sense. For me, covering inexpensive short positions is one such rule.

Knowing the answers to the following questions helps define your comfort zone and thus, develops correct and profitable trading habits.

- Do you really want to take the risk associated with earning the last couple of nickels on a trade?
- Can you handle increasing negative gamma that comes with very short-term positions?
- Can you sleep at night when your short options have become ATM options?
- Do you know exactly how much cash can be lost if something unexpected happens?
- Have you chosen a trade strategy that suits your needs? Or are you copying someone else?

- Do you know yourself? Are you aggressive or conservative? Greedy or do you have a reasonable profit target? Seeking a fortune or satisfied to use options to augment your income?
- Do you recognize the truth? Options are not for everyone and if you truly don't understand what you are trying to accomplish with your trades, that's okay. There are investing alternatives.
- Do you trade with a confirmation bias, or an open mind?

MORE ADVICE

- Don’t be stubborn. If you missed an earlier opportunity, do not miss another opportunity. It’s okay if the trade is not as good right now as it was earlier. You live in the present and must trade accordingly.

- Concentrate on developing a trading style, but there is no urgency for the newer trader. This includes selecting strategies that you understand and feel comfortable trading. I prefer iron condors, but there is no good reason for any reader to do the same. There are several good ‘income-generating’ strategies that rely on positive theta to make money.

- When learning all about options, please take your time. I know there is an eagerness to get to the next chapter, the next lesson, the next book or blog post. Absorb the information at your own speed. Learn the basics before moving ahead. Have patience.

CHAPTER 13
OPTION TRADING AND SLIPPAGE

One negative aspect of option trading is that we frequently encounter wide bid/ask spreads. There are exceptions, but we have to anticipate seeing wide markets when we want to place a trade. That does not suggest it is *always* difficult to get orders filled at a decent price, but it does make it difficult to get a good estimate the price where you can easily get your order filled.

For example: You see a credit spread with a market of $1.00 bid and $1.60 ask. There is little chance of selling the spread and collecting $1.45 or $1.50 (unless the price of the underlying asset changes). To achieve that price, there would have to be a buy order for the spread that you are selling; the order would almost certainly have to originate from a retail trader; and your offer would have to be the lowest available price at the same time that the customer's order is still active (not yet filled). That's quite a long shot.

For the most part, we have to trade with market makers. However, if the options that we prefer to trade are very actively traded, it is quite possible (don't expect it to happen very often) that one customer may bid for the option we want to sell while another is offering the option we want to buy. When that happens, our broker's computer should be able to spot the bid and offer and almost instantaneously trade with both orders to complete your trade at a favorable price. That's the theory. In practice it would require that both orders be present simultaneously *and* that neither order is good enough to get filled immediately by the market makers, *and* that there is no other order (similar to yours) that could grab those two option orders before your broker's computer can act. That is another longshot.

The point is that trading is not cheap. Every time we enter an order we must expect some slippage (getting orders filled at a price that is worse than the midpoint). If we assume that the middle price—between the bid and ask— is a fair price, then almost every trade is going to be worse than that fair price. Because that happens, we cannot afford to trade too frequently. NOTE: Do not refuse to make a trade just to avoid slippage, but do avoid making frivolous trades.

When we use income-generating strategies, we earn money through positive theta (time decay). We overcome that slippage by holding onto our trades. It is important to recognize a potential mindset error: We are not entitled to time decay profits. When we hold any position, the market may not behave. We may wait for theta to come our way, but we could lose far more money than theta provides. Waiting to collect theta comes with risk.

We cannot ignore that risk and must apply our risk management skills as needed. We hold positions when they are working, risk is within our comfort zone, and there is no other compelling reason to adjust or exit the position. That is how theta is collected—by taking risk. It is not something that just drops into our bank account.

TECHNICAL ANALYSIS

When using technical analysis to make entry and exit decisions, the trading game is all about timing. Non-option traders may exit a trade within seconds or minutes, earning a few pennies per share per trade. Overcoming slippage prevents (or extremely limits) the probability of being able to grab a quick profit when trading options.

With the type of strategies ("income-generating") that I most often recommend, we take into consideration special items that are of no interest to the short-term equity trader:

- Is the implied volatility high or low? In either situation, we plan to hold the position until IV reverts to the mean. The equity trader wants the stock price to change, and option premium levels are of no importance.
- Has the market been volatile or calm over the recent past? The success of your strategy may depend on the stock market remaining volatile or calm. The equity trader looks only for the predicted price change.
- Is the market trending higher or lower? Traders who follow a trend, hold positions, allowing whatever time is required for the trend to work.
- Is any major news event overhanging the market? That often affects the implied volatility of the options and you may prefer to exit prior to that news release.
- Do you have too much delta, gamma, theta or vega risk? Risk is measured by the Greeks. When any specific risk factor is too high for the personal comfort zone of the trader, it is prudent to reduce or eliminate that risk

The Winning Mindset

When a trader anticipates a decent-sized market move over the very short-term, and wants to make a bet on the direction of that move, the best play is to own an in-the-money put or call option, with the premium as low as possible (minimizing losses if the option becomes worthless). There is no reason to buy or sell a spread with its embedded slippage.

NOTE: When you make this play because news is pending, expect option prices to be high. When 'everyone' knows that news is coming, options are in demand (lots of buyers, fewer sellers), and prices move higher. When it is known that a price gap (either higher or lower) is more likely than usual, options become attractive for the speculator—despite the higher-than-normal premium. Be cautious when making a bullish or bearish play (buying/selling single options) under these conditions. Spreads are almost always a better value (because spreads come with less vega than single options) for the buyer and provide a ton of extra safety (by limiting losses) for the seller.

Never delay a needed adjustment or exit because of trading costs. Slippage is part of the cost of doing business. This does not mean the winning trader pays the ask price or sells the bid price. Traders always try to get trades executed at decent prices, but know in advance that some slippage occurs when trading.

- Be aware of trading costs. That includes commissions, exercise/assignment fees, or anything else that your broker charges when filling an order.

- Avoid trading when the profit potential (after commissions) is too small.

- NEVER worry about trading expenses when the position is outside your comfort zone. Risk management comes first. Use common sense or understand the position Greeks to get a handle on what can go wrong with the position.

CHAPTER 14
HOLDING A LOSING TRADE

"Dear Mark,

"How can the $155 Salesforce (CRM) call be priced at $4, and the $160 call trade at $2.50 – which makes the breakeven price for option buyers $159 and $162.50 respectively? The stock is only $147 and there are two days left before the options expire!

"This is a very juicy premium on OTM options when the stock has little chance to reach the strike price. Why is the implied volatility so high (it is 157)? Am I missing something?

"By the way, the regular 3rd Friday Aug options have already expired and my broker is still showing some August options that expire on Aug 24 (the *fourth* Friday)."

THE REPLY

These Aug 24 options are "Weeklys" options and there is nothing weird about the expiration date. The truly unusual thing is that you want to make a trade using those options despite the fact that there is some factor about them that confuses you. The exchanges list options that expire at one-week intervals for some of the most actively traded stocks and indexes. That is the situation for CRM options.

It is difficult to establish rules that always apply to trading situations. There are almost always exceptions for every rule. However, this rule is mandatory:

Trade ONLY items that you understand. If the expiration date, underlying symbol, strike price, premium (or anything else about the option) seems 'wrong'—do not make the trade.

Please be 100% certain that you know these options are not something special and different.

It is so true that we don't know what it is that we don't know. *This time* there is nothing to fear because the option exchanges have been listing Weeklys options for some time and they are standardized options in every sense except for that unusual (to you) expiration date. I'm surprised that you were unaware of their existence—especially when you want to make a trade.

It is also important to recognize when something is too good to be true. There are too many situations in which the unaware trader can get into trouble. And news pending is one of them.

EARNINGS NEWS. A quick Google search tells me that quarterly earnings for Salesforce will be announced after the close of trading on Thursday, one day before these Aug 24 options stop trading. The very high implied volatility tells you there is something strange going on. It is not a smart move to trade those options when you do not understand the reason for the high premium. That is why I searched for the earnings date. You could have done the same. Once you discover the truth, it becomes possible to make a good decision about buying or selling these options.

I note (from other correspondence) that you do have a source for earnings dates, but you must know that the accuracy of such lists is not guaranteed. I hope you understand that options do not carry such high premium unless something special is in the works. No one pays such 'absurd-looking' prices for options without a valid reason. Similarly, no one should sell these options without understanding why the premium seems to be far too high. If you do not know what that something special is, then it is far better not to trade.

I hope you did not just sell a bunch of these puppies.

The follow-up message

"Hi Mark,

"I failed to exercise due diligence, my broker's platform did not display the earnings date in the column where it was supposed to be, and I did not double check elsewhere. I will do that due diligence from now on.

"Selling a bunch of these puppies is way out of my league. That would

be WAY over-leveraging. I did sell one 165 call at $1.40 yesterday. I was thinking that it is some kind of error and I wanted to get in on the action small—pure greed and no plan on my part—I curse myself now as this was imprudent.

"And one day later (it is still prior to the news announcement) **I don't want to take a $15 loss** and I can justify to myself the plan to hold to expiration by this reasoning: stock already had a nice run up in past ten days on earnings expectations. Dividend per share is negative because they are still acquiring and building their empire. So, some smart money that is already invested, may unload now. And most important—**I still have a $17.50 cushion in the stock price before I start losing money**."

MY REPLY

Be careful. Not wanting to take a loss is a dangerous mindset: *You already lost money*. It may only be $15, but right now your trade is underwater. Sure, there is a very good chance that you will earn a profit if you continue to hold, but a decision is required: Do you want to take the risk that comes with seeking the potential profit? I cannot help you make this decision. Your position size is good, so no loss is likely to really hurt, but a decision is still required. You should not make this decision on whether or not your trade is currently profitable.

Your reasoning is a perfect example of confirmation bias. You want to be right. You do not want to admit making a mistake, so you justify the sale of the call option.

You are allowed to remain short and you are allowed to hold the position. I strongly urge you to do that only for the right (reasonable, realistic) reasons. In my opinion, none of your rationale is reasonable. The worst reason of all is refusing to accept a $15 loss. If that tiny sum gets in the way of good decision-making, how can you expect to manage risk for any position that faces a good-sized loss?

If you had no position and were first looking at these options (now that you know about earnings news) would you feel the same? Is your rationale truly that of an unbiased person? Far too often we 'talk our book.' That phrase means that we say, and make ourselves believe, that we have an unbiased reason for our beliefs when in reality, those beliefs are 100% dependent on our position. We want to believe we made a good trade. We want to believe that we made a smart trade. If we lose, we are going to chalk it up to bad luck. "Talking your book" is not a viable mindset.

You have a very good chance to earn a profit. The problem is that there is no good estimate of your exposure. We have no idea how high this stock may rise during one day of euphoria.

If earnings are disappointing, or only slightly bullish, when the stock next trades (Friday morning, after the news is out) the stock will not move near $165 and you will be able to cover at $0.05 or wait for the end of the day. I would buy those options. On occasion, the market reconsiders its original interpretation of the earnings news because the ensuing conference call offers unexpected future guidance.

The point here is that you can gain no more than the $145 premium

collected, but your potential loss is far larger. Is it an acceptable risk? For most traders it is acceptable to hold onto a one-lot—if they allow themselves to sell naked call options. Now that you understand what is involved when being short one call—and believe me when I tell you I understand— perhaps you would not make the trade knowing what you know now. However, you have a different problem. You cannot bring yourself to accept a small loss as the price of learning an important lesson. ***That is an impossible mindset over the longer term***.

Do remember that the stock may run another 30 points after the Friday-morning opening. Be aware of what you are doing.

Your primary goal as a trader is to make money—from today into the future. Staying short this call option is one way to do that, but be certain that is the position that you want to own.

Do not think in terms of: 'I still have 17 points of safety,' or 'I sold this option and I cannot cover.' Those 17 points (and more) can disappear at the opening. That is only an 11% move. It is unlikely, but not impossible. The important lesson about earnings news and price gaps is this: The option is not priced to accommodate a typical bullish rally. It is priced for the fact that some portion of the time, the option is going to be so far ITM when the stock opens, that the average value of the option is $145.

MORE FROM THE MESSAGE

"Should I be afraid to let it expire if CRM opens far below strike price?"

Yes. If you win this time, plan to cover at $0.05 because the stock price may change during the conference call.

The true decision is whether to hold thorough the announcement. You should not take this risk just because you sold the call. You should take the risk only if it is justified. So now that you know the pluses and minuses, you must decide whether to hold or cover.

"I got out with a small profit when stock dipped earlier. I chose not to wait through the earnings news."

All's well that ends well. I like your final decision to exit. However, please (please):

Do not manage risk

by getting out of a trade that you do not like only when it is profitable, and holding because the trade is losing money.

The best part of this is that you learned a couple of BIG lessons and it cost nothing. Traders are not always so fortunate.

The Winning Mindset

I only trade markets that I understand. I will not trade specific options if the price seems to be FARout of line unless I discover the reason for that out-of-line price. Why? Because trading those options assumes that everyone participating in the market is being foolish. That is not possible.

I will only trade an option when I know the details, including ex-dividend and earnings release dates. [One example: The spot VIX is NOT the underlying asset for VIX options. The underlying asset is a VIX futures contract with an expiration date that differs from that of the VIX options.]

If I do not know why an option can be purchased under parity (for less than itsintrinsic value) I will not make the trade. Options are never available under parity(European options may be under parity in certain situations because they cannot be exercise before expiration) and thereforethere is something about the option premium that I do not understand. After mergers, spin-offs, large special dividends, the deliverable may be other than 100 shares of underlying stock. It may include cash, bonds, stock in another company etc. [The “deliverable” is the package that a call owner buys (or a put owner sells) when an option is exercised.]

There is no such thing as a free lunch. There is no free money. These may be clichés, but they are true on Wall Street.

CHAPTER 15
WHEN TO EXIT

One big part of my job as an options educator is to help traders develop a healthy mindset about trading. This reasonable-sounding note from a reader illustrates a subtle point.

"Mark,

"I hold two iron condor positions and the profit so far is very modest because I had to adjust each of the trades when the market rallied. I am hoping to build up those gains by waiting until Friday or maybe Monday to close. I realize I am at risk and could lose even this modest gain, especially as the positions have a growing negative gamma.

"But, isn't this the trade off we always face? I am willing to risk holding a little longer."

REPLY

Let's first discuss your current positions. Then we will look at the problem as a choice between two mindsets.

Yes, this is a common problem: Do we take what we have or continue to hold? Iron condor (and similar) positions come with positive theta (time decay) so we are *programmed to prefer holding* to exiting. However, we do not get that theta for nothing. Nor do we want to do the "obvious" without making the rational decision that the "obvious" represents the best course of action.

We always accept the risk of seeing the underlying asset make a substantial move. You may believe that your discipline is top-notch and that you will be quick to exit once such a move starts, but even the most disciplined traders may be away from the computer screen for a short time or may get stubborn for a few minutes. Even worse, sometimes the markets gap at the opening leaving you no time to act before losses become significant.

Thus, the constant decision: hold 'em or fold 'em. In your example, there is no reason to get out right now, when the market is so calm. Once the market opens and you escaped the risk of an opening gap, it is reasonable to plan on holding for the remainder of *that one day* before deciding what to do next. Just recognize that holding overnight presents another gap risk.

I know you want that weekend time decay, but big news events can occur over the weekend. Also consider the fact that market makers are sophisticated folks and they do not want to load up with weekend time decay either. Thus, option prices often decline on Friday. Look at it as a weekend discount. Thus, exiting Friday is not as painful as it seems because you sacrifice less time decay than you may expect. You should compare Friday/Monday price changes to see how this works for your specific underlying asset.

You probably know all that and understand your alternatives. However, I'm raising these important questions:

- Why does the fact that your gains are modest affect your decision? You know that if the trades had been big winners you would avoid all additional risk and accept those juicy profits.
- Why is it so difficult to accept modest profits? You made a risk-reducing adjustment to each position. That step probably reduced overall profit potential. Isn't the modest profit good enough under the circumstances? Aren't you pleased to have any profit after going through a rough period?

- You seem to be concerned about the chances of seeing these 'modest' gains disappear. I may be misinterpreting your feelings, but it sounds to me as if you are no longer within your comfort zone and that you refuse to exit because you believe you 'deserve' more.

  You held the position until now (I assume the primary driving force behind the hold decision is that there was no profit to take, so you did not exit), and now you want a payoff. That is perfectly normal. However, it does not represent sound risk management.

- Why is it difficult to see that you already earned a nice profit and a big payoff? By adjusting instead of exiting earlier, you were able to move an underwater trade to the profitable category. That's a nice recovery from where you were. Yet that does not seem to matter. Do you know why you think that way? It seems 'natural' doesn't it? The key question to ask every day is: Do you want to own this position right now?

Regarding the mindset alternatives
In my opinion, it does not matter whether you have a current profit or loss. It does not matter whether the trade is a big or small winner.

You own a position right this moment. Do you like it? Does it fit your investing/trading objectives? Do you still want to own it? Nothing else matters. I do recognize how difficult it is to live by that idea. We all want to hold trades until they become profitable. There is nothing wrong with that concept, *as long as the position is worth holding*.

These positions are either comfortable to hold or they are not. Look at the current premium you would have to pay to exit. Would you prefer to own the specific position we are discussing today—at that price? Or would you prefer to exit because the risk and reward combination is just not good enough to warrant holding? Isn't that all that matters?

Why should the original price of the trade (and your current profit level) make a difference in how you feel? You had a loss, salvaged the trade, and now have a profit. Isn't that good? Do you need better?

The past is history and you own this trade right now and have to make the hold/exit decision. That decision should not be difficult to make. And if you cannot make it; if there is true doubt; then exit half and hold half. **NOTE:** When exiting in this scenario, there is no emergency. You do not have to pay the ask price nor sell the bid. Enter a reasonable limit price that has a good chance to be filled.

Right now, with the underlying in its sweet spot (no shot option is being threatened) and expiration rapidly approaching, some traders would love to hold this trade. I prefer to find a low-cost exit. But it is your decision that counts.

Make a new plan. You must manage risk, and may have to abandon the trade under duress. However, you have more flexibility when you are on the winning side simply because more options are available to you. Suggestions: Plan to scale out of the trade, a few lots at a time. Pick your profit targets and exit when they are achieved. Do not be stubborn. If the risk/reward picture changes, so must the plan.

I do not like hard and fast rules. I prefer that a trader learn to think for himself under stressful conditions. Right now, there is no stress (!) and that's wonderful. Some trades are like that and we have to count on them to make our biggest profits of the year. It would be unfortunate to take a loss here, but it remains a possibility.

The bottom line is that you are willing to hold a little longer. This time, I concur with that decision. Sitting at the sweet spot does make a difference. However, I must stress the idea that avoiding an exit

because the profit is too small is not a long-term viable way to trade.

You will face a similar decision every day—for every position that you trade— (if not every hour), until you finally exit.

The Winning Mindset

I know it is not easy for every trader to accept this way of thinking. However, I firmly believe it distinguishes between the gambler and the person who wants to run trading as a profitable business.

I cannot base a hold/exit decision on my profitability for the trade. Each position is worth holding (or folding) based solely on where it stands at the time a decision must be made. This is similar to the hold/adjust decision. The right mindset is to ignore P/L and recognize that the current position is either good enough to own *now*, or it is not.

If current risk is unsatisfactory (either too large or too imminent); if the current remaining reward is too small, if I feel uncomfortable with position delta, gamma, vega, or theta; if I am torn between my choices, then it is time to close the trade and remove risk and anxiety from my life. If I have a nice profit, that's a bonus. But it does not affect my decision. If I have a loss, that's not as nice, but it does not affect my decision.

My goal as a trader is to make money. That means trading for profits and holding positions that have good potential.

My goal is to exit unworthy positions because those positions are likely to result in losses. Another subtlety: The position may have been worthy of your trading dollars when it was initiated, but if things change and the position has shifted to the dark side (may the force be with you), it is time to get out.

ANOTHER VANTAGE POINT

You know what a profit is. It is exiting a trade when there is more cash in your account than when you made the trade.

You know a loss when you see one: Your account has less money in it than when you initiated the trade.

I have an underwater trade and choose to make an adjustment (rather than exit). That risk-reducing adjustment trade turns a $400 loss to a $50 loss. To me, that is a real $350 gain to my portfolio. A different trader may correctly call it a loss and not a profit, but it is a big

recovery from the point at which the trader could have decided to exit. In fact, it is such a good recovery that I would be pleased with the result. Wouldn't any trader? If instead of that $50 loss, it were a $50 profit, wouldn't that still be a good result? Sure the latter is better, but neither should be a disappointment.

Please do not believe that the profit is insufficient because it failed to meet pre-trade expectations. This trade did not work as planned. An adjustment was necessary. You managed the trade well, earned a good recovery, and yet you have a need to write a larger profit number into your trade diary. My advice is to take the good result and exit the high-risk position.

If you continue to hold, only two things can happen. The first is that your profits will increase and you can do a bit better than where you stand today. The other is that the profits begin to fade and the final result depends on when you pull the trigger. Isn't that gambling?

This is a business, not a gambling casino. I must own good inventory. I am not married to this trade just because I expected a better result.

CHAPTER 16

ADJUSTING: HOW MUCH SHOULD I INVEST?

A trader buys (or sells if you prefer that terminology) an iron condor, collecting $250 credit. The market moves against the position and the trader decides that he is no longer satisfied with his holdings. For the purposes of this discussion, let's assume that one of the short options is not far enough out of the money for this trader's personal comfort zone. Something must be done. He can adjust, reduce position size, or exit.

Keeping this discussion very basic allows us to focus on one specific point: Is there a limit on how much cash a trader should invest in this position when making an adjustment? The goal is to transform this iron condor so that it becomes good enough to hold.

Let's assume that the trader faces two (and only two) choices:

- Pay $400 to close the trade, losing $150 per iron condor.
- Pay $300 to roll down the threatened spread to a more comfortable set of strike prices, using options with the same expiration.

Let's make the following assumptions

- This adjustment trade is something the trader wants to do. It is not the result of forcing an adjustment for the sole purpose of 'refusing to accept a loss.'
- The adjusted iron condor is a position the trader is pleased to own.
- Potential gain from this point in time is good enough to justify any risk associated with owning the position.
- The trader's comfort zone is no longer violated.
- The loss ($150) is less than the maximum allowable loss, as described in the trade plan. (Establishing a maximum loss encourages discipline.)

- Considering alternative adjustment trades is not part of this discussion.

The losing mindsets:

- "I refuse to take the loss when there is even a remote chance to turn this trade into a winner, and therefore I will not exit"
- "I refuse to adjust any trade when the best possible result (after adjusting) is a small loss."

When adjusting the $250 iron condor, most traders are willing to spend up to $150 or perhaps $200 to 'fix' the position. That allows for the possibility of coming out ahead when the smoke clears.

There is another group of traders who would make this trade–even when they dislike the newly-adjusted position.

Why would anyone do that? It's done in an effort to eke out a profit from the trade, despite the fact that the new position is not worthy of being in the portfolio. It's done because the trader postpones an unhappy ending. In other words, no loss has been booked yet, and the trader believes that when the trade remains open there is a chance to exit with a profit.

It's true. Such a chance exists. But it is far better to give up this bad trade and try to earn money from an appropriate fresh trade.

In other words, the adjustment was made *only* to avoid locking in a loss. The trader knows his chances of success are poor because he already dislikes the newly adjusted position. Nevertheless, avoiding the locked-in loss (for the moment) is the mindset that haunts him. I hope there is no doubt that this is a losing mindset. Some positions will lose money and they cannot be salvaged.

In my opinion, abandoning a bad trade and substituting a new trade that meets the trader's needs should produce better results, on average. Traders are not well served with a mindset that makes them unwilling to let go of their losing trades.

There is a different scenario to consider: The situation changes when an adjustment costs more than the initial credit. When the adjustment would cost $300, this group of traders refuses to make the adjustment because the best possible result for the post-adjustment trade–

assuming the best possible result–is a loss of $50. Our trader is not going to own a trade for which there is no way to earn a profit. For this trader, adjusting when the cost is more than the initial credit is out of the question. He exits.

This is a *common* way of thinking. The logic feels impeccable. After all, a trader cannot earn money when the trade cannot possible be close for a profit. Surely (says the incorrect mindset), it has to be better to exit right now.

This represents the loser's argument. If you come away from this book understanding why this is not the winner's mindset, then I know you will be a more successful trader.

The better mindset: "I am not willing to exit when there is an adjustment that gives me a position that I want to own and which comes with an excellent opportunity to recover part of the loss."

Let's look at the trader's situation from a different perspective. Ignore profits and losses for a moment and consider:

- The iron condor is no longer priced at $250. The current market value is $400.
- When making trade decisions today, it is not efficient to dwell on a trade opportunity that is no longer possible. Look at the numbers now and decide on the best action to take now.

Also consider this: The trader is willing to spend $400 to exit the trade, but is unwilling to spend $300 to adjust the trade, even though

- The new position would be good enough to own as a brand new trade.
- The new position is likely to earn money from today until the position is closed. Translation: The final loss is likely to be less than the current $150 loss.

Yet, the trader prefers accept the loss, rather than adjust. This cannot be a sensible decision.

There is no disputing that some trades should be closed. However, basing the adjust/exit decision exclusively on how much it costs to adjust the trade is not a sound practice.

That mindset is very common. I encourage readers to accept the following argument instead:

It is better to own a good position when it is available at a good price, rather than refuse to own it because it was built from a previous, losing trade. If you would open a new position that is identical to the position that you refuse to own because it is the result of an adjustment, then something is not making sense. The position has the same chance to earn money from today into the future–regardless of how or when it was born.

Your records may tell you that it can never be profitable (based on the original entry price) to own a specific position, but that does not mean you must reject the adjustment trade. If you allow recordkeeping to affect your trade decisions; I suggest finding an alternative method for keeping your trade records.

Do not ignore an opportunity to earn money from a position that meets all your criteria for a good trade. This is the heart of the argument:

Position A has been adjusted and now has a locked in loss. The best you can do is recover $250 in losses from right now until expiration.

Position B is a brand-new trade that can earn as much as $250 from right now until the identical expiration date.

Assume each position is deemed to have equal risk and the same probability of earning the maximum available profit.

Then, it does not matter which

position you own. Each position increases your net worth by $250 at expiration, compared with your net worth today.

The Winning Mindset

Do I want to own my current open position now? Do I believe I can earn money from this position? Is there any reason to avoid the trade?

Or is there a better trade that I can make right now? In other words, should I quit this trade and invest my money elsewhere? Is that other trade more attractive? Do I have enough capital to own both trades? Is that a viable idea?

The winning mindset allows the trader to consider those questions. It does not require closing a position because the original trade generated a cash credit that is no longer relevant. We own a position right now and must decide whether to exit the trade or make a risk-reducing adjustment that requires a cash investment.

Buying good positions at a favorable price with a decent risk/reward ratio–isn't that how we select our trades?

If the trade is good enough to own it does not matter that it is an adjusted trade with a locked-in loss. It is far better to earn money (and we only do that in the future) from a good position than to give up on a trade because of some bookkeeping consideration. A trader's job is to grow the account value by owning positions with acceptable risk and reward possibilities.

When thinking about the cost of adjusting, that decision must be made among current choices, and has nothing to do with the original trade price. The choice is: exit at today's price; or adjust at today's price. Make the better choice.

That's the path to success. However, it does require adopting a mindset that may be difficult to accept.

CHAPTER 17

MAXIMUM ALLOWABLE LOSS

Let's continue the discussion from the previous chapter, but from a different perspective. It is time to think about one situation that occurs (hopefully, not too often) for traders. When the winning trader initiates a new trade, he writes a trade plan as part of the process. The specific portion of the plan that is the focus of our attention is setting a maximum allowable loss for the given trade.

Definition: During the lifetime of a trade, if the total loss reaches a specific level, the disciplined trader closes the position and accepts that loss. This serves two purposes. First, it gets the trader out of an uncomfortable position. There is a big psychological benefit when doing that because the trader can now forget about the risky trade, the mounting losses, and anything else that bothers our trader when working to manage a position that is not going well.

Second, it prevents a pending disaster. The trader who procrastinates or is willing to keep the position open 'just a little longer' may discover that he soon reaches the point where he tells himself: there is 'no way I'm going to take a loss that this large.' If you don't believe that this thought can occur to you, please think again. The same mindset that encourages a trader to hold a position until it 'gets back to break-even' (Chapter 11) is at work here. It is so tempting to believe that things cannot get much worse (or at least not get much worse very quickly) and that there is still time for the trader to show discipline and take defensive action. It is a fact that some traders hold short credit spreads until they achieve the worst possible result (spread reaches its maximum value). The same is true for iron condor, butterfly, diagonal and calendar spread traders. Some lack the discipline to take the action promised in the trade plan.

If you ever allowed a 5-point credit spread to reach that $500 maximum value (i.e., both options are in the money at expiration), then you understand how it never seemed to be an appropriate time to exit. Once the spread reaches a certain point, many traders just close their eyes and hope for the best. For example, no one would pay $490 to exit because the maximum additional loss is only anther $10 and because it is still possible for the spread to lose value, allowing the trader to get out with a much smaller loss.

But, if you would never exit by paying $490, how about paying $480

or $470? Doesn't it seem right to hold once the position is that far underwater? It has to seem reasonable to risk another $20 or $30 for the small chance to recover up to $470 or $480 if you get an unexpected lucky break.

This reasoning can go on and on. When that happens, there is never a point at which the trader I willing to accept the large loss and get out of the position. For that reason, it pays to establish a maximum possible loss and that means getting *no later than* when that loss is achieved.

The whole point of this discussion is to avoid holding onto any trade until it reaches a price at which you decide that "there is no point in exiting now."

WRITING THE TRADE PLAN

Let's be honest, writing a trade plan often seems to be a waste of time because traders believe they will act appropriately—if and when a trade decision becomes necessary. However, writing the plan makes decisions easier to make. In other words, pulling the trigger on an adjustment (or other action) is much less difficult when the decision was made in advance, under non-stressful conditions. Those advance decisions include:

- Establishing a target profit to be certain the trade is worthwhile and to help the trader take on too much risk by being greedy.
- Establishing a maximum allowable loss for this trade.
- Deciding at what point (price for the underlying asset, delta of short options, time to expiration) you want to make an adjustment because at that point your risk parameters will be out of line with the boundaries of your comfort zone and that action to reduce risk is needed *now*.

We all know that taking losses is a necessary condition for traders. We all prefer not to take those losses. However, refusing to take a loss is a dangerous mindset. There is no good reason for owning a position when:

- You no longer like the position, for any of a number of reasons.
- The trade has become too risky to hold.

- The trader's maximum loss for the trade has been reached

TRUE STORY

As described in the previous chapter, it may be difficult for some traders to invest more than a predetermined sum into a position adjustment. I've received several comments/questions on this topic from readers. Whenever an adjustment costs more than the maximum possible profit from the original trade, it is easy to abandon the trade —rather than make a solid investment that truly makes the position worth owning.

Important clarification: The discussion below assumes that the adjustment is *good and that it is necessary*. It assumes that the adjustment is not made for the *sole* purpose of avoiding an exit that locks in a loss. This is a very important point. Many traders adjust just to stay in the position. Do not depend on good luck to protect the assets in your trading account.

There is nothing wrong with exiting when you are uncomfortable with a trade. Thus, the decision to exit is always acceptable. If you prefer never to adjust a position, that is acceptable. It may not be the best long-term methodology, but if it feels right to you, then do it. Being comfortable with trade decisions is one way for the trader to avoid stress.

When you have a choice between two reasonable alternatives it's important to make the trade that leaves you satisfied. We may not talk about psychological situations very often. However, it is always advisable to avoid trades that leave you emotionally unsatisfied. Here is one simple example. If the choice is between buying in a short option vs. waiting until it expires worthless, I am happy to buy that cheap option. So I do it, even when the option is hopelessly far out of the money. Feeling good about my trades is important. Just remember that the final, adjusted position must be one that you want to own.

If the above conditions above are not satisfied, then choose the exit. Why did our trader choose to exit the original trade (Chapter 16), paying $400 instead of making a good adjustment and paying $300? Answer: Because of a losing mindset. It is not uncommon for traders to abide by certain 'rules' with no idea of the rationale behind those rules. Note that closing the position was not wrong. It was just the less appropriate choice for most traders. Remember that if this person did not want to adjust—for whatever reason—that is acceptable.

Assuming that any adjustment is made for appropriate risk-management reasons, then the true decision is based on looking at

your choices right now, and ignoring your initial trade:

- Do you prefer to invest more cash at the current price because risk/reward and profit potential look good?
- Do you prefer to invest the necessary cash – right now – to get out of the position (exit)?

You cannot do both.[Ok, you can exit half the position and keep the other half. However, this discussion involves how to think about deciding what to do, so let's keep it a 'choice between alternatives' decision. Choose between exiting or adjusting.]

The Winning Mindset

The original premium should play no role in the adjust/exit decision—If you are a disciplined trader (with a track record to prove it), then you can be flexible—for the correct reasons—once a trade reaches the maximum allowable loss. It is not a good idea to believe that you are disciplined. Demand proof (track record).

You have a position—at today's price. *Nothing can be done to change that.* You must exit, adjust, or do the unthinkable (take more risk than your account, trade plan and psychological health can handle.

Do not foolishly throw good money after bad trying to salvage junk. But do not be afraid to make an investment that gives you a good chance to earn money going forward.

This logic can be applied to any position—even when you already lost as much as you are willing to lose for any given trade. If you truly understand and believe that the arguments made in this, and the previous, chapter represent the best way to handle this situation, then the 'max loss' rule does not apply. You should NOT hold the position as it exists, but tt is acceptable to fix the trade—if and when you reach that 'max loss' level. However you must be honest with yourself. The 'fix' has to be real. It has to severely cut imminent risk. It has to produce a position you honestly want to own.

The reason that the 'max loss' rule serves a good purpose is that it prevents traders from allowing losses to hurt a trading account. If you do not have the discipline to handle the very difficult decision of cutting losses at some pre-determined point—then please adopt and always use that 'max loss' rule. It is in place to protect a trader against making an unreasonable decision under self-imposed duress. If and

when you reach the maximum allowable loss, you will be under a lot of stress and may not be prepared to make the best decision without a trade plan to follow.

CHAPTER 18

THE KILLER BLIND SPOT

From my perspective, the most important aspect of teaching risk management to newer traders is helping people see the big picture because being aware of just how much money is on the line is not something that comes naturally. It is so much easier to make a trade, feel good about it, and then pay far less attention than necessary as we wait for our deserved profits to appear.

Traditional investors buy stock or mutual funds and seldom (only after a huge decline), if ever, worry about losses or give any consideration to limiting risk or learning how to hedge their holdings.

As individuals, we each see 'risk' differently. That's one reason why there is more than a single definition of risk when the topic is money:

- The sum that can be lost.
- The probability of losing money.
- The probability of losing it all (blowing up a trading account).
- The risk of taking too little risk and as a result, limiting profits.
- The risk of not playing on a level playing field; i.e., being at a competitive disadvantage. In today's market, with computer algorithms providing so much of the trading volume, I have no doubt that we individual investors are at a competitive disadvantage.
- The risk of not knowing what it is that we don't know.Things that appear to be obvious may not be true. My favorite example: VIX options do not use the CBOE VIX index as the underlying asset. Instead, VIX futures contracts represent the underlying.

TALK ABOUT NOT SEEING THE BIG PICTURE! The following

statement is one of the most perplexing risk evaluations I ever heard from a trader whose main strategy is selling naked (unhedged) options.

Discussing the result of a short strangle trade on a volatile stock, he made the following statement after the naked short put position was closed:

"I was never in any danger. The stock was always higher than the put strike price and the options were never in the money."

While he was holing this position, the options moved from far OTM to almost ATM and increased in value from $0.80 to more than $20. That represented a loss of more than $1,900 per option contract—and he thought that he was *never in trouble*.

This gambler was convinced that the only time risk had to be considered was when short options had already moved into the money. In his mindset, when the options were out of the money, and remained OTM, then the options would expire worthless and the seller would have a tidy profit.

I can't argue with part of the sentiment. If those options (as eventually happened) never moved ITM, then the person who sold them would eventually get to keep the original premium as 100% profit. We all know that OTM become worthless once expiration day has come and gone.

However, that mind-boggling first sentence that describes any out-of-the-money option as nothing to be concerned about leaves me in a state of shock. Sure, we can try to convince ourselves that an OTM option is not going to move ITM, but the very fact that we would never sell such options as our initial trade ought t be enough to tell us that we do not truly want to be short an OTM option that carries a $20 premium.

Unfortunately, this mindset is not unique. A number of option sellers believe their original premise—that selling this put will prove to be profitable—that they fail to recognize danger when they see it. Yes, this trader was in *big trouble*. The $1,900 per option wasn't even the major problem. This trader failed to recognize *the possibility* that this stock, after making a significant move, could continue to move in the same direction. There was no reason to believe that this move was coming to an end.

Gamblers who do not recognize just how bad things can get tend to

sell too many options. They are convinced that selling far OTM options is the path to earning easy money. And the truth is that the strategy works quite well when greed is absent and the trader knows when it is time to abandon a trade and accept the loss.

Another problem: It I impossible to hold all trades to expiration, hoping for good results because low probability does not mean zero probability, and those 5-delta options can move ITM. And they will, approximately one time in every 20 trades.

The person quoted above has little experience. “I was never in trouble” tells the story. When he was short those options priced at $20 each (that is $2,000 cash per option), he had enough assets in his account to cover the margin requirement. Had that extra cash not been there, he would have been forced to buy those options to exit the trade.

This time, the trader was blind to risk and came out unscathed. His mindset tells me that he will not survive long because he will tempt the fates until he suffers a loss that wipes out his account.

There is no doubt that our trader got lucky this time because the stock price steadied and remained above the put’s strike price.

His blind spot is much more difficult to understand. If the stock could make a big-sized move to place his short put almost ATM, why couldn’t that decline continue, moving the option price from $20 to $40? I have no answer to that question. However, that this blind spot can exist among inexperienced traders is one of the reasons why I believe it is crucial to any trader’s success that he learns about risk management very early in his trading career. As Dr. Brett Steenbarger(noted psychologist, trading coach, author, and blogger, he contributed a ton of important writings in the area of ‘psychology of trading.’) said:

> “if the importance of controlling risk early in one’s career is not understood, there is a good chance that it will be a short career.”

Selling 100 (equivalent to 10,000 shares of stock) of these cheap, far-out-of-the-money puts probably seemed very safe when the trade was made. However, at the worst point, the loss would be almost

$200,000, or more than enough to decimate the accounts of the unwary.

One of the basic truths about investing (even when it would be more truthful to refer to it as gambling) is that some people with little experience believe that it's easy to make lots of money in a hurry. I don't know why that's true, but the fact that skills must be developed over time is a foreign concept to such traders. Trading, as a profession, gets little respect. No one would try to become a doctor or lawyer without any training, but some trader wannabes do not have that limitation.

Confidence that a current investment will eventually work out is a common feeling (confirmation bias). Stocks decline and many investors like to add to their positions, increasing risk in a losing trade. The mindset is that the stock does not have to rally too far to reach the break-even point. For example, buy 1,000 shares at $50, then buy 1,000 shares at $40 and the break-even is 'only' $45. Add another 1,000 shares at $30 and the trader's mindset is that this stock will easily get back to $40, the new break-even price.

There is no consideration for the possibility that this company will soon be out of business. This investing newcomer just knows that his original analysis must be correct. That overconfidence hurts many a trader.

THE NAKED PUT SELLER

The put seller described above believes that being short an out-of-the-money option is of no concern, as long as it remains OTM. He just doesn't get it. He fails to understand that he *has already lost* a ton of money and that the possibility of losing a far more significant sum is staring him in the face and he truly doesn't recognize the danger.

I'm not suggesting that this oblivious mindset is common, but it is not rare. As option traders we must be careful to avoid that mindset. I'm sure that most reader understands the risk of being short naked options, but too often that understanding comes from suffering the consequences. Why does it take a big loss to convince some people of the possibilities?

Being oblivious to risk can will result in a disaster. How large of a disaster? That depends on just how blind the trader is to the true risk of any position. It is ok to take risk, but know that risk and do not exceed your personal limit.

THE SPREAD SELLER

As an example, let's look at a trader whose preferred strategy is to sell OTM put spreads, rather than selling naked puts. This is a common strategy for bullish investors (and one that I recommend).

Let's assume that one trader correctly decides that selling 10 puts with a strike price of $50 is the proper size for his/her account. Even oblivious traders understand that the maximum loss is $50,000. They also recognize that the chance of losing that amount is almost zero, and that it is difficult to know just how large the realistic maximum loss is. Sure, a stop loss order can establish that limit for a trader, but stocks have been known to gap through limits, leaving the trader with a larger-than-anticipated loss. The 'flash crash' (May 6, 2010: The DJIA plunged about 1,000 points (9%), and recovered those losses—all within a few minutes.) The decline was not steady and many stocks gapped to incredibly low prices (pennies per share), before moving higher.) This is a rare extreme example of how bad things can get in a hurry. **NOTE**: Some of the most outrageous of these trades were "busted" by the powers that be.

What happens when this trader decides that selling naked puts is no longer the best idea and opts to sell 5-point put (sell the $50/$55 put spread) spreads as a 'safer' strategy? Each spread can lose no more than $500 (less the premium collected). The problem arises if the trader, not understanding risk, decides that selling 100 of these spreads—with a maximum loss of less than $50,000—is a trade with essentially the same risk as selling 10 naked puts. That would be a big mistake.

The probability of incurring the maximum loss (or any loss) must be considered. It's easy to incorrectly believe that risk for these two trades must be similar when the maximum loss is the same. These two positions have vastly different risk profiles.

To lose $50,000, the naked put seller would have to see the stock priced at zero. For the 100-lot spread seller, the $50,000 loss occurs when the stock is below $50 when expiration arrives. That is a far too common situation and the correct position size remains 10 contracts. If you would consider selling 10 of the naked puts, then sell 10 put spreads instead. Sure this trade offers less possible reward, but the possible loss is reduced from "gigantic" to a reasonable $5,000 (less premium collected when selling the spreads).

The trader whose mindset includes being oblivious to reality, tends to ignore statistics as well. The big factor when comparing the naked put with the short put spread is probability.

There is a reasonable chance of incurring the maximum possible loss ($50k) when selling 100 five-point credit spreads. Depending on the strike prices and the volatility of the underlying, the chances of losing the maximum can be near zero to almost 50%. When selling ten naked puts, the chances of losing that same $50k are far less. That's the big blind spot: Selling a bunch of limited-loss spreads will, on occasion, result in a maximum loss when the trader gets unlucky or careless when managing risk.

When the chances are one in five, or even one in 10 that the trader will suffer the maximum possible loss (when both options expire in the money), you know that such results are going to occur (on average) once every five or ten times. It takes some good-sized wins to overcome those giant losses. The trader who sees selling ten naked puts and 100 put spreads as 'similar' has no chance to win the options-trading game.

One important aspect of risk management is understanding the likelihood of collecting the target profit or incurring the maximum acceptable loss. The size of that profit or loss does not tell the whole story.

Please do not be an oblivious investor. Understand how much is at risk (and the chances of losing that sum) as well as the target profit for each position in your portfolio. Pus, be aware of the same elements for the entire portfolio.

The Winning Mindset

As a rookie trader, I understand that selling naked options can lead to substantial losses and is best avoided. After I gain the experience and confidence that comes with being a successful trader, and after I prove that I know how to limit losses, it is permissible to sell naked option in appropriate (small) size.

I always know my maximum loss for any trade. However, I cannot measure risk solely by the number of dollars that can be lost and I always consider both the maximum loss and the chances of incurring

that loss when choosing position size.

CHAPTER 19
ROLLING FOR A CREDIT

When seeking information, all too often traders ask the wrong questions, such as: 'How much money can I expect to earn when trading options?'(See Chapter 10.) That is a question with no answer. Many variables affect a trader's earning power, such as the trader's experience, bankroll, aggressiveness, willingness to work, personal discipline etc.

This chapter is concerned with a common practice that represents a similar and dangerous mindset. That way of thinking can be summarized with the phrase: "always collect cash when making an adjustment."

There is a subset of option traders who try to avoid paying cash for anything. They make trades such that all opening trades and adjustments involve no out-of-pocket cash. If they cannot find a *good* adjustment for a cash credit, then they create a trade that provides that credit. For example, they may elect to sell extra spreads, i.e., sell more spreads than they bought when covering the original short spread) or sell spreads that generate a relatively high premium, despite the fact that these spreads violate the trader's comfort zone. In other words, generating that cash credit trumps all other considerations. That is not a sustainable strategy.

The general strategy is to allow all options and option spreads to expire worthless, but on occasion they may be willing to pay a small sum to exit a profitable trade.

The problem with adopting this trade-for-a-cash-credit philosophy is that traders often find themselves owning a newly adjusted position that is already outside their comfort zone. They would never own this position if not 'required' to do so by their trading rule. Demanding that all trades produce a cash credit severely limits adjustment choices.

The trader with a winning mindset recognizes that risk management trumps everything else and that it is far better to exit a bad position than to turn it into yet another bad position.

MANAGING THE TRADE

Credit spreads begin with a cash credit. If all goes well and time passes, the options lose value and may eventually reach a point where the trader is willing to cover. However, paying a few nickels to eliminate all risk is not a popular among choice the 'always collect cash' crowd.

Think about what can happen when the market goes against the position. The rate at which losses accumulate increases (due to the negative gamma of such positions) and the risk of a big loss increases. The first adjustment may result in a decent position. However, when the market continues to rise (or fall), the second adjustment is almost always going to require covering the current position and selling spreads that are farther out of the money. To compensate for the reduced premium, additional spreads are sold. This is very similar to the Martindale strategy in which a player keeps doubling his bet until he finally wins. Of course, sometimes the string of losses is large enough that the player goes bankrupt. In the options world, it does not take too many doubles before the trader has exceeded his margin limit.

Traders with a rational mindset, such as: "This position requires an adjustment because my current risk is too high and I must avoid a large loss" have no trouble making good trades that reduce risk. Most of the time, these trades involve spending cash.

The only advice I can give to you is to state my firm belief that trading for a cash credit always feels good, but it should not become the overriding decision-making factor. To prevent falling into that career-dooming mindset, I suggest the following thought patterns when adjusting a position:

- Reduce size; buy back a portion of the position.
- Buy single options to gain delta and positive gamma.
- Buy debit spreads for limited protection. But do not buy spreads that are farther out of the money than the short option being protected
- Buy…In other words, be willing to pay some cast when adjusting. Adjustments with risk-reducing, positive gamma are not free.

MINDSET

An adjustment is easy to find when no attention is paid to risk. A trader may enjoy selling extra spreads to collect extra premium because it affords an opportunity to make even more money. The fact that overall risk has increased is ignored. The dollar signs are all that he sees.

If this overly optimistic thought process seems unbelievable, just know that some traders believe that any option sold will expire worthless. And if it doesn't, a simple roll will solve the problem. This mindset is a combination of too much confidence coupled with confirmation bias. The important takeaway is: When risk increases after an adjustment is made, that adjustment did not do its job.

SELLING PUT SPREADS AS A BULLISH ADJUSTMENT

Consider this high risk adjustment trade: When the market rallies, an 'obvious' adjustment choice is to sell put spreads. That delivers some positive delta along with extra cash, but it comes with more negative gamma and provides *no significant help* when the rally continues. Even worse, downside risk has been added. Selling new put spreads without covering the original put spreads (the iron condor position is short both put and call spreads) is not in my playbook. Prudence dictates paying some price to get those puppies off the street, but the intrepid cash-collecting trader does not think that way. In fact, in his mind those options have already expired worthless. I hope it is clear that is dangerous thinking. It may be very unlikely but something horrendous can happen, and with it can come an unbelievable stock-market decline. There is no reason to take such risk when paying a small price can eliminate that risk.

WHAT ABOUT ROLLING?

Rolling is a good risk-reducing technique, but is often used inappropriately. Rolling is a term describing a trade in which the current position is eliminated (covered) and a new position is sold as a replacement.

I prefer to roll down (that means choosing a new, farther OTM, spread with the same expiration as the spread being covered)—without selling extra spreads. That always costs cash. For the 'always collect cash' trader, rolling down requires the sale of extra spreads to prevent paying cash for the trade. The (incorrect) justification for making that

trade is: ‘these options are too far OTM to become a problem.’

Increasing position size is appropriate when the position being fixed was less than the trader’s maximum AND the extra spreads can be sold at a good price AND the new trade is something the unbiased trader wants to own. It does not work when used as the standard adjustment trade that ignores other factors.

Rolling works when you convert the ‘at risk’ spread to a good position with less immediate risk and no increase in overall risk. It is not always possible to find a suitable trade. When that happens, it is better to exit and accept the loss. You can always open a brand-new position that is suitable for current market conditions.

When the new trade results in a position that is far from neutral and requires an immediate adjustment, it is not a suitable trade. Begin anew with a good-to-own position.

ROLLING DOWN AND OUT

Traders often roll down and out (farther OTM and a more distant expiration date) with the belief that they can find a way to protect assets by making almost any trade that postpones expiration, as long as it does not cost cash. The truth is these trades succeed often enough to convince the trader that this should be the preferred adjustment trade. And that *sets the trap*. Choice is limited. Increasing the number of spreads sold becomes the only alternative when the trader must collect cash.

EXAMPLE: Rolling down and out. It is July 1. INDX is 1030. Implied volatility is relatively high for INDX options. If it were lower, the trader would have to sell additional spreads to avoid paying cash to adjust.

1. Trade: Sell 10 INDX Aug 1100/1110 call spreads.
2. INDX rallies. Roll the position to **12 Sep 1120/1130** spreads.
3. INDEX rally continues. It is Jul 15. Roll the position to **15 Oct 1140/1150** spreads.
4. INDX soars to 1125. It is Jul 20. For this trader's comfort zone, the short strike should be 1200 or higher. For even money, the trader can sell **25 Oct 1200/1210** spreads and cover 15 Oct 1140/1150 spreads.

Trade size has increased from 10 to 25 contracts; margin increased from $10,000 to $25,000; the position remains at risk; and it is still three-months before expiration. This trader has lost money and is in trouble. Imagine if another roll is required! There is no reason to get into this kind of trouble. By paying cash, the trader would not have increased position size. By paying cash a trader could have *really* reduced risk instead of just believing that risk was reduced. True, profit potential would be less. But that is nothing compared with what this trader has done to his overall risk.

Note: When you move your short options farther OTM, you probably 'feel' safer. And you are safer from the perspective that it is *less likely* that additional money will be lost or that another adjustment will be required. However, a reduced probability of losing money is not good enough when the sum at risk has increased by so much. You never

want to allow for the possibility of blowing up your trading account with a single position.

From the perspective of ‘money at risk’ (that’s how I suggest risk be measured), position size has increased and risk has increased.

If you take the stance that there was no need to sell extra spreads because the trader could have rolled less far OTM, you are correct. But that offers another unhappy choice. This trader is truly trapped with poor choices (when unwilling to spend cash): Too much size or a position where the options are not far enough out of the money.

The trader with the winning mindset is never caught in this trap

THE IMPORTANT POINT FOR THIS CHAPTER

A simple roll down isn't good enough for some traders and they prefer the down and out trade because it can often be made at a credit. However:

- The rolled-out position comes with additional time to expiration and many traders prefer to trade short-term options
- Despite a trader's confidence that the market cannot move any higher (or lower), it can and it will. These extra-large positions are not as 'safe' as they feel.

NOTE: These positions 'feel' so safe because the trader believes that the position can be rolled again (and again) whenever it becomes necessary. The trader believes that cash can be collected repeatedly until the trade finally ends with all options expiring worthless. This is an illusion because each roll comes with additional risk, suggesting the inevitability of blowing up the trading account.

I suggest avoiding rolling out until you have worthwhile experience adjusting option spreads using other methods (and even then I do not recommend the down and out roll).

The risk-increasing down and out roll trade violates the very first rule of successful risk management: Avoid increasing position size because it increases potential loss. Repeating the improper mindset: "The short options are father OTM, and the index cannot rise forever. If the new trade gets into trouble, I'll just roll down and out again."

This is a perpetual process until the options finally expire worthless, *or the trader's account expires worthless*.

Rolling for a cash credit often makes the trader falsely believe that no loss has been taken and that there is still a good chance to collect the entire (original) premium as a profit—but it's an erroneous belief. The truth is that the loss has already been locked in. The trader now owns a new position that not only has additional risk, but it is also a position that may not be acceptable as a new position. This is essentially the same problem we discussed earlier (Chapter 11, trading to recover losses).

EXIT

Getting rid of a bad position is a relatively easy choice for most traders—once the decision to 'do something' has been made. Take the profit when it hits your target and move on to another trade. To the cash-is-king trader, buying in cheap options is a waste of money and the trader believes that options were made to expire worthless—another misconception and dangerous belief.

If the mindset described fits you, please think about modifying the way you plan to manage risk in uncomfortable scenarios. It is not necessary to collect cash from every trade.

The Winning Mindset

I adjust only when the after-adjustment position is good enough to own, at a cost that is worth paying. There must be a reasonable expectation of earning a profit from today into the future, with an acceptable level of risk.

I never force an adjustment. If I believe that closing the position and taking a loss represents a good choice under the circumstances, I'll exit with no second thoughts. It is difficult to find a good adjustment every time that a position becomes uncomfortable to hold.

There is nothing inherently wrong with collecting cash when adjusting a position. However, I am careful to turn the position into one with less imminent risk and less ultimate risk. The cost to adjust is not my primary concern.

It is a simple concept: I manage a portfolio so that it contains good positions. I do not micromanage. If I own good positions and make good risk-management decisions, I will come out a winner in the end.

It is tempting to roll a losing trade into a more distant expiration. It feels as if the loss has been postponed with an improved chance to come out a winner. It is an illusion.

If I roll down (same expiration), I consider the new position as the original trade for bookkeeping purposes, with an adjustment.

When a position is moved to the next month, I consider the first trade closed and I now own a brand new position.

I must answer yes to this: Is this the position I want to own now? If 'no' then I do not adjust.

I do not get trapped into a bad new trade. I do not roll out to a later expiration. I exit and find something new. I plan to make money going forward, and I own positions that are well suited for that purpose. If I must accept a loss to get out of a poor position, so be it.

CHAPTER 20

THE TRADE OR THE TRADE PLAN: WHICH IS MORE IMPORTANT?

Two divergent paths are available for traders. We learn to make good decisions that lead to profitable trades, or we don't. My objective in writing this book is to help traders understand how to make those good trade decisions.

Anyone can buy or sell options. However knowing what you are doing and having a viable plan lead to success. Traders cannot afford to take shortcuts. Trading is not an easy game. Take the time to learn, practice, and understand what you are doing.

Those who are not cut out for the multitude of decisions required of traders may turn out to be very successful investors. The main difference between the two is the frequency of trading and the holding period. There is also a mindset difference.

The trader must know:

- How much cash is at risk for every position?
- What must happen for position risk to increase beyond his comfort zone?
- The steps a trader can take to alleviate that risk.
- When is the appropriate time to take those steps?

When preparing to open a new position, I encourage you to write a game plan. I know it may seem unnecessary. And perhaps it is for some trades. However, by writing the plan and keeping a trade diary that includes your thoughts – before, during, and after exiting – a trade, you will have an excellent collection of data. Periodically reviewing the numbers and your thoughts can only make you a better trader. Looking back, you will discover thoughts that were clearly mistakes. Not so much errors, but decision that you made as a less-experienced trader. These are mistakes that you will not make again.

The less-experienced trader is not yet aware of which decisions belong in the plan. No problem. As you gain experience it becomes clear which items deserve to be in the plan. Begin with estimating the target profit and maximum acceptable loss. Include some comments about the rationale behind the trade. If you do not know why it makes sense to make this trade now, then perhaps it would be better not to do so.

After a few trades, the trader has a much better feel for the reasons behind setting up a trade and establishing targets. To develop good habits and a winning mindset, begin making a written trade plan with the very first trade. The plan will probably be short, with a profit target some thoughts on how much you are willing to lose. But the next plan will contain more information because you will realize that you have more ideas to put in writing. These plans soon become valuable. As stated above, the true value comes from looking back on your trade diary (or you may prefer to refer to it as your trade journal) and analyzing your decisions.

If you believe (as I do) that having a trade plan is a good idea, the question becomes: which is more important; the plan or the trade? If we don't want to 'put the cart before the horse,' then we have to know which the horse is. Translation: Is our priority to develop the plan and then make trades that rigidly follow that plan? Or do we trade as we deem best at the time that decisions are made -- and use the results to develop a plan for future trades? This may seem trivial. However the winning trader understands the role of the plan. You truly have a choice: The trade plan is gospel or it is merely a strong suggestion for managing the position.

The lengthy discussion below illustrates one trader's thought process on a single strategy and how he developed a trade plan. My comments are included *in blue*.

Note: For some readers this discussion will be too detailed. My reason for including this chapter is to illustrate how small differences (or omissions) can make a big difference in how a trader handles a position. That in turn has a significant impact on results.

BASED ON A DISCUSSION IN THE OPTIONS FOR ROOKIES FORUM (now closed)

"Mark,

"I am revisiting the idea of buying a double calendar. [Two simultaneous calendar spreads on the same underlying asset (same expiration). Typically one strike is above, and one below, the underlying price.] Earlier, my challenge was in not knowing when to take a profit on the winning side (i.e., on the calendar spread that is showing a profit, and ignoring the other side). Now I have a different thought.

"In my paper trading account, I opened the following double calendar with RUT @ $840: Total debit $12.70

Buy RUT Nov/Dec 795 put spread
Buy RUT Nov/Dec 880 call spread

"When the market runs toward either the call or put strike, I will exit that calendar at a profit. [Calendar spreads widen as the underlying price moves nearer to the strike price.] If implied volatility increases (a common occurrence on stock-market declines) perhaps both calendars will increase in value. If that happens, I will exit the double calendar with a profit. If not, I will proceed with the following plan...."

[MDW] I see problems.

Do you have any reason for making this trade? The general reason for owning a double calendar is an expectation that implied volatility (IV) will rise. This position is long a lot of vega [the Greek that measures the sensitivity of an option's price to a change in IV].

We previously discussed (Chapter 6) iron condors, agreeing that the trade is a single position and that there is no (except for discussion purposes) 'profitable side' and no 'losing side'. That mindset also applies to the double calendar because the double calendar is one position and the objective is to exit the whole position with a profit.

1. Your plan calls for selling one calendar spread 'at a profit.' That is not enough information. How much profit? What are your criteria for deciding when to exit? Dollars earned? When strike is only X points OTM? Would you sell all at once or scale out by closing

the position a few spreads at one time?

With no specifics, do you plan make random decisions on when to exit 'one side' of the position? That is not a plan; that is trading by market feel. This is the wrong strategy for that trading style. If you plan to make bullish and bearish trades at times that you deem to be appropriate, then you do not want a spread that is so rich in vega. You want to trade delta [the Greek that measures the change in an option price as the price of the underlying asset changes], not a position whose profit potential is so dependent on vega.

My bottom line thought: Would you exit either side if the price were less than the $12.70 paid for the whole DC (double calendar)? If yes, how do you plan to collect enough additional cash to earn an overall profit? Markets do not reverse direction just because you want them to do so.

2. Going farther: Why are you looking at this position as if it were two separate trades? The correct mindset is to consider any trade as a single position. It may be practical to manage risk as if you owned two separate positions when risk for half of a position threatens to turn into a large loss), but you should not have a trade plan that calls for managing one side at a time.

Let's look at risk as the market moves lower.

> *a) You know that a market rally will kill the value of the call calendar (because it becomes farther OTM), and that is an excellent reason for selling some (or all). That decision is all about managing risk. I know that you would probably refuse to sell the call calendar (as an adjustment) on a decline because (from the perspective of your mindset) it would be locking in a loss on the call half of the double calendar.*
>
> *b) When the market does decline and the underlying asset is trading near the strike price of the calendar spread, and especially when some time has passed, that put spread will be*

trading at a high price (true, 'high' is a relative term, but at some price it will become very stressful to continue to hold). If that spread were, for example $15 to $20 holding becomes a high risk proposition. If time passes and RUT holds steady or moves even closer to the strike price, the calendar spread would gain value, and that would be excellent. However, if IV declines (when the market is no longer falling) or the RUT makes a sudden rally, the calendar spread will lose value. And if RUT rallies far enough, all of your profits would disappear. [Anytime the put spread can be sold for more than your original $12.70 debit, the trade would be profitable.] When would you sell? What is the plan? Do you have a target profit, or will you decide to sell when 'you fell like selling?'

When looking at the DC from a risk perspective, do you know whether the put spread will gain value (declining market) faster than the call spread loses value? As I read it, your plan is to pick a time to sell the put spread and then hope to convert the call spread into a profit source (more on that later).

The call calendar lost a lot of value when the market declined, and I see that you discuss what to do about that below.

3. Trading the double calendar is more complicated than waiting to exit one side. You never mention position delta. Is delta management something that you plan to ignore because you prefer to concentrate on only the calendar spreads?

"The plan then is to buy (to close) the short option in the call calendar (i.e., the Nov 880C), and then sell the Dec 870C to complete a Dec 870/880C credit spread.

"At this point, the only concern may be: how much can I collect by selling the 870C? I would be selling the 870C for not a whole lot. I am aware of this. But the fact is this 870/880C spread would be pretty FOTM by that time."

I see more problems.

a) RUT moved much lower and no adjustments were made. You are waiting to sell the put spread at some unspecified price or time. As mentioned, with no adjustments, this is a risky play because the call spread could have lost almost all of its value. True, the passage of time may be good for the put spread, but unless RUT declines further, you may never be able to earn a profit.

Unless the double calendar is earning money as the market moves in one direction, it is not a trade that works with your plan. Data is needed. I suggest collecting P/L data as RUT changes price and as time passes.

You do not want to adopt this strategy because you read about it somewhere. Remember, this is not a typical strategy that traders use to play rising and falling markets. This position is all about volatility.

To trade any strategy, you must know how it makes/loses money. That is the only way to learn how to manage the trade (i.e., how to devise a trade plan). Right now you don't have a viable plan. When paper-trading, collect data and use that data. You may conclude that this is a poor strategy for everyday use.

b) Once that put spread is closed you plan to convert the remaining calendar spread into a far OTM call spread. As you mentioned, holding that spread is unlikely to generate much profit, and it is loaded with risk.

c) Your plan is to cover credit spreads when they trade at low prices (because there is so little to gain by being short such spreads) when trading iron condors. Why do you want to take the opposite view now? It is far less risky to sell the long call (thereby closing the calendar spread) than to convert into a spread that could haunt you later. And that is

especially true when the profit potential is so small.

"Alternatively, maybe I can move closer to the money when I initially establish the double calendar. This is to address the problem of collecting too little premium when opening the new short strike (Dec 870C)."

Warning: This is the crux of the problem.

You adopted a strategy. You selected a trade. A rational assumption is that you chose the position you wanted to own. Now you are considering a different trade. Not because you prefer to own that position, but because it would be easier to manage the least important portion of the trade – namely what to do with the low-priced call spread after you sold the put spread (at a high enough price to generate a profit). That is not efficient.

Let's slow down and consider what you are trying to accomplish as a trader.

- *Make money by taking appropriate risk.*
- *Adopt an appropriate option strategy.*
- *Plan the trade setup: Choose specific options to trade. Decide whether cost of trade makes sense. Know both profit target and ultimate risk. Write viable trade plan.*

Question: Which mindset gives you the better opportunity to earn profits on a consistent basis?

a) I love this plan and I selected my trade based on which position works best with that plan.

b) I like this trade and can develop a trade plan that lets me manage the position efficiently.

c) I will consider both the trade setup and the trade plan. The idea is to find a good

compromise that allows for a decent profit with as little risk as possible.

d) I will choose which options to trade so that I can make a less-costly adjustment. It does not matter whether I feel comfortable with the original position because the adjustment process will be easier.

I don't have research to support either a) or b). However, most traders make a trade that suits their needs (and market outlook) and then make a plan to manage risk. Choice b) feels right to me. If you must emphasize the plan, then adopt c) and allow the specific trade selection to be important in your life.

You are considering developing the plan first (to be certain it is viable), and then finding a suitable trade. This feels backwards. Especially when you are so concerned with managing the very low-priced position (the residual call calendar spread) that can be held or sold without having much influence over the eventual profitability of the double calendar trade. To repeat: This risk-management decision has little effect on the overall profitability of the trade, and therefore is not very important. Your goal with the residual position is to be certain that it NEVER causes pain. Hold, close, or adjust, you do not want a low-probability chance that the future will bring a significant loss when there is not much to be earned.

The choices require very different mindsets. Most traders (and I agree) believe that risk management is important and cannot be ignored. However, the trade chosen has to be one that offers the best chance for earning a sufficient reward, considering the risk involved. Risk management comes into play in selecting trade size, target exits, and when risk-reducing action is needed. Risk management is not the driving force behind writing a trade plan. Therefore choice d) is completely inappropriate.

It is an excellent idea to practice the DC, with the goal being to learn whether this strategy can produce profits, and especially when to adopt this strategy. In the

scheme of things, what you decide to do with that low-value call spread is unimportant—as long as it does not become a source of additional risk. Handling that put spread (in your example) is critical to success. I see no reason to use options with different strike prices when you already chose the options that you prefer to trade.

The one crucial factor that is missing from this whole discussion is" Why the double calendar? What attracts you to this strategy? I do not know why this strategy appeals to you because you have no plan to make money based on the special properties of the DC. What has to happen to generate that profit? You do not mention vega, the most important factor in this trade. You anticipate the market will move to the strike price of the calendar spread, but there is no estimate of how much you believe the winning calendar will be worth.

Here is the key point: If the plan included a calculation and stated something along these lines, then I could see a path to profitability:

> *"If RUT moves to the $800 to $805 level three weeks after the trade is opened, and if IV increases by 5%, I calculate that the theoretical value of the put calendar would be $13.50. If I can unload at that time, I'll have a profit for the trade (I paid only $12.70). I also show that the call calendar would be worth $0.75. I could hold that part of the position as an inexpensive bullish gamble, but I will not. I need that $0.75 because it represents a big portion of the profit."*

> *"If RUT required four weeks to reach $805 and if IV increases by 10%, the calendars would be worth $14.60 and $0.80. That's why I like this trade."*

> *With no statement of where profits will come from, I do not know how you will make money. With the IC we know we make money when time passes and the markets are not moving much. We have profit targets. Here, you made a trade with only a general idea to sell one side 'at a profit.' I suggest that you figure out how this trade makes money before taking the risk of owning it.*

Depending so heavily on this plan assumes that a sale of one calendar spread will occur 'at a profit'. What if it doesn't? What if time passes and losses increase? Do you have an exit plan or an adjustment plan?

I believe that the trader should depend on good trade selection to lead to profits and that the trade plan is best used to establish ideas for when to adjust or exit the trade. The risk-management plan is not the source of profits; it is the method we use to protect our assets.

I admire what you are doing. You want to determine whether the double calendar can work. However, I believe the emphasis must be on discovering the profit source.

BACK TO BASICS

This returns us to the most basic points: Why would you trade the double calendar? What market conditions? What is the profit target and does the underlying have to move towards one of the strikes to make money? What is the result if the shorts expire worthless, RUT is unchanged, and IV is 5% lower?

When you answer those questions, the next (mandatory) question becomes: Do you want to trade closer-to-the-money options, or did you choose appropriate strikes in the first place?

My opinion is along traditional lines: Do not select a specific trade for the sole reason that it is easier to manage if something specific happens.

I recommend entering into a good trade and then creating risk-reducing, profit-collecting, ideas to suit the trade. The trade is the dog. Do not allow the tail (trade plan) to wag the dog. The trade is more important.

"What do you think of managing a double calendar this way?"

Not much. You have no profit target. You have a vague idea that you will sell one half of the position at some undefined price and will turn the other half into a high-risk, low-reward position. I do not like the management plan.

To proceed, plan to find answers:

- *What market conditions lead to profits?*
- *Must the underlying asset move near one of the strikes to earn profits?*
- *What has to happen for you to believe that the trade has gone badly? How much would be lost by that time?*
- *Is it helpful to neutralize position delta?*

- *Is vega the key to profits? Does anything else matter?*

> *The double calendar is dependent on implied volatility and thus it is difficult to know its value at any point in the future. That is the true risk of owning a double calendar trade, and you have not addressed that risk factor.*
>
> *You are searching for a management scheme that works for a double calendar position. It is FAR more important to know why you want to own the position, when it's appropriate to initiate this trade, and how to choose the strikes. Do you expect IV to rise? Do you see an aberration between the volatility levels of the Nov and Dec options? Is that where your edge lies?*
>
> *Your plan has to include a rationale for making the trade (such as: I am selling a put credit spread because I am slightly bullish; or I am trading an iron condor because I believe the market is going nowhere). Why do you want to own the double calendar? The answer should not be: Because I found a neat way to manage risk for that strategy.*
>
> *Once you know why you want that position—and that includes why you expect it to be profitable—the next step is devising a plan to capture the profits.*
>
> *If you manage the double calendar as a single position, the goal is not to take a profit on one side. The goal is to pay attention to the whole position.*

The Winning Mindset

The Trade Plan is an important part of any successful trader's *modus operandi*. Some plans include every conceivable detail while others are very short and include only the highlights.

The trader with the winning mindset writes a plan that meets *his/her* needs. Don't spend time on intricate details before knowing that the strategy can be adopted (and traded profitably).

If you fear indecision under stress, include more details in the plan because it helps you trade. The plan is for your benefit and no one

else's.

Practice trading is beneficial when developing a new idea: new strategy, new adjustment style, etc. Write a trade plan; make and manage the trades; exit and takes notes on the important features of the trade. Repeat. Make modifications. Then decide: Give it a test drive with real money or discard the idea. This stakes time. Be patient.

The trade represents reality. Make a trade when you have confidence in it. For some traders, that confidence comes from timing the entry. For others the trade is based on a belief that the strategy, all by itself, provides a winning edge. Some traders believe their management skills can turn a no-edge trade into a winning trade.

The winning mindset is to find a way of trading that is both comfortable and profitable.

Don't make a trade if the path to profits is not clear.

CHAPTER 21
A TRULY TERRIBLE TRADE

There is one recurring situation that offers the trader with a losing mindset an excellent opportunity to lose money. This situation is all too common as traders take advantage (disadvantage?) of that opportunity.

There is no logical reason why anyone should get this wrong, but it happens.

THE SCENARIO

A Trader made a directional play and sold a call spread on a stock or index. Time passes and the trader changes his mind. He is no longer bearish. In fact, he is bullish and decides to buy some calls.

Current position:

Long 15 Nov 85 calls
Short 15 Nov 80 calls
Stock price: $74

Let's consider a few alternatives (there are many others from which to choose):

1. Buy Nov calls
    1. Possible strike prices: 70, 75. 80, 85
2. Buy Dec calls
    1. Possible strike prices: 70, 75, 80, 85

When the trader has a *losing mindset*, he chooses to buy Nov 80 calls/ Why? For the simple reason that he is already short those Nov 80 calls and decides (with little thought) that must be the best option to buy. In truth, it is the *convenient* option to buy, but it is a very poor choice for the bullish trader.

Look what happens. By covering the Nov 80 calls, he now has a long position: Nov 85 calls. He would never buy those calls when making a bullish play because they are way too far out of the money. Yet, once he covers the Nov 80 short calls, that is what he owns and he is most likely going to incur a loss on his bullish play. Do you want to correctly be bullish and lose money when the stock price rises? I hope not.

The trader with the *winning mindset* considers these alternatives:

1. Which option do I want to own?
2. What should I do with the call spread that I sold earlier?

Notice that the primary decision is based on opening a new, bullish trade. Emphasis is on owning the position that the trader believes gives him the best chance to profit NOW. There is no temptation to morph the existing position into something more bullish.

Once the bullish trade has been decided (I recommend the Nov 70 calls in this example), the trader makes the purchase and then goes about the business of deciding what to do with the remaining bearish spread. He will probably cover it, but perhaps he would keep it as a hedge against the newly purchased calls. Whatever the decision, it is well reasoned and not random.

If he had decided that buying the Nov 80 calls was the best move, there would still be no reason to maintain ownership of the Nov 85 calls. The most likely scenario would be to exit the call spread and buy extra Nov 80 calls.

The Winning Mindset

If I want to own call options (or put options) as a directional play, I will choose the best option to buy when I make the trade. *My decision will not be influenced by existing positions.*

As a *separate decision*, I decide how to handle any existing positions. But the key point is that this is a separate trade and a separate decision. I will not own an inferior position just because it is convenient.

It would be extremely unlikely to discover that the option I prefer to own now happens to be an option that I am currently short. I will buy only the options that I believe will work best for my current market outlook. It is foolish to buy an option for the sole reason that I had sold it earlier.

CHAPTER 22

THE ULTIMATE WINNING MINDSET

Each trader has a reason for getting into the game. The obvious and probably universal reason is to make more money. We all want to enjoy a better lifestyle and avoid the pangs that being short money can bring. The sad truth is that the average working person cannot afford to do much in today's world.

My guess is that none of us will ever have what is considered to be 'enough' money. There is just something about being wealthy that seems to bring on the need for more wealth.

That aside, the trader is looking for additional money and is taking appropriate risk to achieve that objective. The point that I am trying to make here is that there should be some reasonable limit. Why? As long as it is necessary to take risk, there is always the possibility of incurring a big hit. If you have enough, why take that risk?

So I leave you with my ultimate advice for a winning mindset. Most of us will never have a chance to put this into practice, but I now recognize that at one point (actually two different points) I had all the money I would ever need. One reason for feeling that way is that I am not a big spender, and don't need luxurious items, and I do not squander money. However, failing to recognize how well-placed I was, I continued to play the game with more risk (and greed) than necessary.

I offer this advice to traders with the hope that you find an opportunity to put it to good use:

> "When you win the game, stop playing."
>
> Don't just take risk off the table; get out of the game completely

AFTERWORD

We know that any activity that enhances our lives can be enjoyable. That is why we have hobbies. The most fortunate among us have jobs that we enjoy and do not have to depend on finding other activities to make our lives more complete.

Trading can be fun. However, it is not the same as other 'fun' hobbies. You may enjoy playing poker or going to the race track. As long as you have the right perspective and keep wagers small enough so that neither winning nor losing provides any extraordinary pain or pleasure, then such activities qualify as hobbies.

Investing is more serious because it comes with long-term goals that include providing for our financial security. I hope no one looks at long-term investing as a hobby.

Trading is an even more serious undertaking. If we keep it simple and define 'investing' as seeking money over the longer term and 'trading' as looking for shorter-term profits, then we must recognize that the game we play is serious. It can be played for small money. However, traders who make money seldom continue to trade small position size. There is the human nature temptation to trade bigger and bigger size as earnings increase. That's fine to a point. However, never lose sight of how much money is at risk at every moment along the way. Understand that winning streaks do end. Recognize that a string of profitable trades is very likely the result of a fortunate set of circumstances and not a result of you suddenly becoming invincible. Treat your money with respect, especially when overconfidence blinds you to the risk of losing.

When we enjoy an activity and that activity is profitable (the profits do not have to be money) it is natural to expand that activity. Do trade bigger size as you gain experience. However, trade no more than reasonable size. You don't hear this phrase very often, yet it is true: "Size kills."

If you want to be successful when trading, and more specifically when trading options, I hope you will pay attention to the subtleties, suggestions, and insights offered in The Trader's Mindset.

From my perspective as an experienced trader who is trying to pass along some of the many lessons I've learned over the years, I am not so much trying to tell you how to behave as much as I am suggesting

that certain ways of thinking—mindsets—can get in the way of finding success. Please recognize that it may be very helpful to modify their habits or way of thinking to produce the winner's mindset. Towards that end, I offer the contents of this book and my best wishes.

APPENDIX A
GENERAL MINDSET ADVICE

I am not alone in writing about how important a trader's mindset is to his success. The following ideas focus on the big picture.

Dr. Brett Steenbarger warns investors to lose a mindset that suggests that each individual trade is a battle that *must* be won. He uses a baseball player's challenge to illustrate how a trader should approach trading. He urges traders not to become emotionally attached to the results of each individual trade, but instead to focus on the longer-term objective:

> "For a successful trader, a trade is like a single pitch to a hitter. It is one part of one at bat, which is part of one inning, which is part of one game. The goal is to win the game, not to "win" on each pitch…
>
> "For the active trader, there are many trades in a day and there are five days in a week. As long as you don't lose too much in a trade, you can turn the day around. As long as you keep daily losses reasonable, you have a chance for a green week. And as long as a week doesn't dig you into a deep hole, you can still be profitable on the month.
>
> "The goal is to have a successful season: that view makes it easier to shrug off the pitches that get away from you and focus on what is truly important."

Do not take too much risk at any one time—either when the trade is made, or after an adverse move in the market. Your goal is to have a profitable trading/investing career.

***

Asset allocation and portfolio rebalancing are commonly used techniques for managing risk when investing. However, that requires investors to overcome the greed/fear mindset. David Swensen, chief

investment officer at Yale University (They have a LOT of investment money to manage) believes that

> "Dramatic bear markets signal the need for significant purchases of losers, while extraordinary bull markets call for substantial sales of winners. When markets make radical moves, investors demonstrate either the courage or the cowardice of their convictions."

It is difficult for the average investor to battle euphoria by selling his holdings as the markets are surging. It is also quite a challenge for anyone to maintain that re-balancing mindset and control decision making by buying as everyone else is panicking as the market tumbles.

For true believers in asset allocation, unemotional trading is a necessity. Most investors have the wrong mindset and get excessively bullish when markets are topping and bearish when they are bottoming. The 'buy the top' mindset must be eliminated to do the job properly.

***

John Forman, writing The Essentials of Trading blog offers a comment to a common question:

> "I find that many traders want to know how long it will take before they begin making money or before they achieve a specific trading goal. That's the wrong mindset. It assumes that success is coming and all the trader has to do is put in his/her time and the profits will appear.
>
> Trading is not a job in which seniority does any good—unless you use the time on the job to learn and understand what you are doing. The proper mindset, in my opinion, is wanting to know where the trader can find information so that he/she can read about, study—and especially

—practice, various aspects of the new job (trading). This mindset recognizes that work is required to develop the skills necessary for success."

APPENDIX B
PSYCHOLOGICAL CONSIDERATIONS

I've presented ideas that I believe can be adopted easily by traders. Assuming you accept my premise that money earned is your money and not 'house money,' it is not difficult to change how you utilize that money. This is a question of logic: Either you agree with the premise or you do not. Either you treat those winnings as if they are the fruits of your labor or you don't. Either you consider profits to be the equivalent of your salary check, or you don't.

However, it is not always as simple as agreeing with an idea and changing the way you behave. If you accept the premise that conformation bias and overconfidence go together and make it difficult for a trader to recognize the truth in some situations, it is not easy to change your mindset and behavior.

Psychology plays a role. It is not easy for anyone to accept the fact that we have been doing something inefficiently or incorrectly for years (decades?). We have beliefs that we put into practice. Some examples: We know that smoking and drinking sugared soft drinks, are bad for our health, but not everyone can (or wants to) change habits.

You may be convinced that it is necessary to rebalance a portfolio by selling into a bull market, but the fear of missing out on future profits is real. The lifetime plan is forgotten. People hold onto their investments and watch those gains fade away (as the market falls once again), never taking any action. Some people want their cigarettes and Coca-Cola, and the freedom to make choices. But wouldn't you prefer to make winning choices?

Losing habits can be overcome with work. You can change losing mindsets that take your cash. It takes believing the ideas are worthwhile. That's the easy part. You can accept or reject any idea. The difficult part is taking action. Accepting that there is a better way to do things and that you are willing to make the effort is not too difficult. Making the changes is the difficult part.

I don't know what it takes for a market re-balancer to make the first sale as prices rise. I don't know what has to happen for that same person to continue to sell—and resist the temptation to change his

mind and repurchase all stocks that were sold into the rally. But I do know that it takes an effort to recognize the correctness of the overall strategy and maintain the willingness to accept temporary discomfort for long-term success.

MISSING OUT

Fear of missing out. This is a significant psychological factor for a trader. It is exactly the reason why it is difficult for the asset allocator to sell as others buy. It is also the reason that traders stay with positions too long.

They hold losing trades for fear of missing out if and when the market reverses. They cannot tolerate the idea of seeing that this specific position would have become a winner—if they had only held.

They hold winning trades for fear of missing even larger profits. The psychological fear of missing out often overwhelms the need for prudence and risk management. This is one reason why a trade plan has to include a profit target. That target gives the trader a solid piece of advice from someone he trusts (it was his own advice when the trade was initiated), making it easier to exit the trade when that target is achieved.

The proper mindset is to understand that trading is a business. When your customer pays your asking price, you sell the inventory and find a wholesaler who has more inventory to sell. Don't fear missing out. You are not in business to gamble.

The direct opposite of fear of missing out is the fear of taking a loss.

TAKING A LOSS

We know that losing trades are in our future. We know that allowing losses to run is the biggest obstacle to our success as a trader.And if you don't know this, give the idea more consideration. Profits are great, but the big threat to a trading career is blowing up an account. That comes from failure to recognize risk.

For many traders, pulling the trigger to exit or refinance the position (paying cash to improve or adjust the position) is recognizing that the trader was 'wrong.' It is accepting the fact that whatever it is that encouraged you to open the trade in the first place has not come to pass.

Once the position is corrected to reduce or eliminate risk, it will be impossible to meet the initial trade objective. A trader has to accept this reality.

It's not personal. Statistics tell the story. We know that the 80% probability trade is going to be profitable trade 80% of the time, but only if our risk manager persona allows us to hold the position until it expires.

Do not worry about what might have been. Once you exit a position, accept the fact that you made the best decision that you could at the time that a decision had to be made. Losing money on some percentage of your trades is part of every trader's game plan.

NOTE*:* Adding onto a losing trade (doubling down, dollar cost averaging) is the same as holding a losing trade, hoping for a reversal. If a trade is not going well, do not blindly hold. Do not blindly add to it. Re-evaluate and decide whether adding to it is a good idea. Sure, it could be a good idea. However, the losing mindset is that the original trade premise is still good (because you never make mistakes) and thus, has to be even better now that you can add to it at a better price.

Avoid that losing mindset. It is a trap. Do not get married to any position. Only own positions that are good right now. Unload positions that are not worth owning in the current market. It is okay to take a loss. In fact, it should make the trader feel good because he knows that he can operate a successful business and make difficult decisions.

The list of psychological examples is lengthy. If you develop the

winning mindset you will discover other situations that can be handled more effectively.

OTHER BOOKS BY MARK D WOLFINGER

MY BOOKS:

The Rookies Guide to Options, 2nd Edition (2013)

Create your own Hedge Fund (2005)

The Short Book on Options (2002)

MY EBOOKS:

Introduction to Options: The Basics (2014)

Writing Naked Puts (2014)

The Short Book on Options (2002, 2014)

Lessons of a Lifetime: My 33 years as an Option Trader (2010)

Introduction to Options: The Basics (2014).

Book ONE. (Volume 0) Writing Naked Puts (2014)

ABOUT THE AUTHOR

Mark Wolfinger has been in the options business since 1977. He began as a market maker on the trading floor of the Chicago Board Options Exchange. He also worked for trading companies as an off-floor trader, trainer of newly hired traders, and risk manager. He now serves as an educator of public investors, showing them how they can intelligently and conservatively use stock options.

Born in Brooklyn, New York in 1942, he currently resides in Evanston, Illinois with his life partner Penny. He received a BS degree from Brooklyn College and a PhD from Northwestern University (Chemistry).

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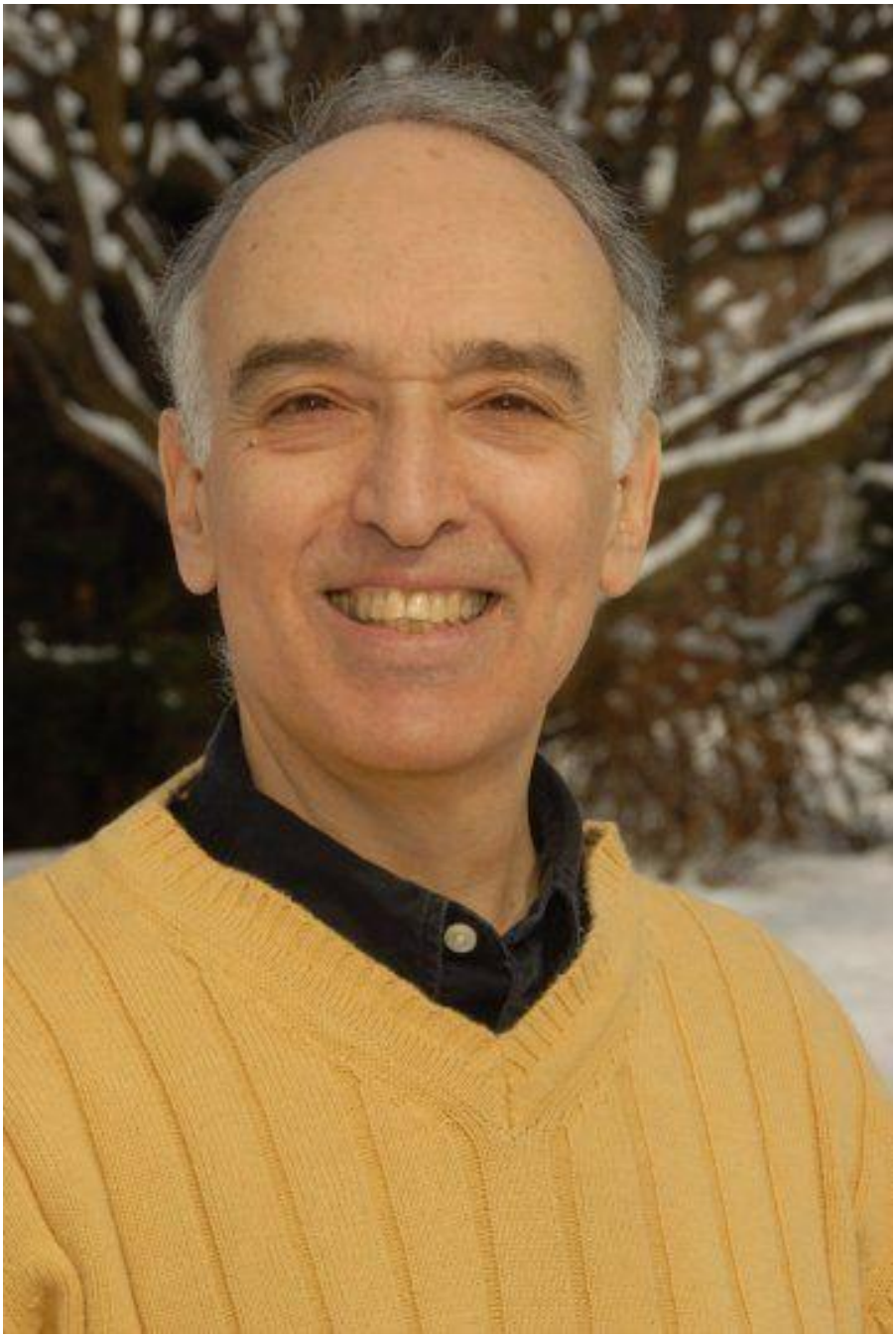

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